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# FOREIGN EXCHANGE IN INDIA

*Sometimes* Editor, *Bombay Chronicle*,  
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## PREFACE.

In 1925, in consultation with Mr. S. V. Srinivasan of Thos. Cook & Son, I had occasion to address a letter to Sir Basil Blackett, the Finance Member of the Government of India at the time, suggesting the formation of an Indian Institute of Bankers. Sir Basil immediately adopted the idea and wrote to Sir Norcott Warren, Managing Governor of the Imperial Bank of India, asking him to interview me and discuss the question. Sir Norcott was frankly pessimistic about the possibilities of the Institute and could not understand why the London Examination should not continue to be satisfactory to Indian bank employees. I tried to make him see that, in all the subjects of study, a syllabus for Indian bankers would be different from the London one ; that the principles of Economics of an agricultural country were different from those of other nations ; that Commercial Geography for us was more concerned with our products, their distribution and the time when the crops would be harvested, instead of being concerned with the distribution of manufactures produced throughout the year ; that the law of bills in India was often at variance with English theory and practice ; that even for English, there could possibly be another syllabus for India ; and lastly, that, in the subject of Foreign Exchange which seemed more universal, there was a fundamental difference between India and England. I am glad to say that Sir Norcott then became converted into one of the warmest supporters of the proposal for an Indian Institute of Bankers and became the first President of the Institute.

My prophecy, that the Institute would number more than a thousand members within two years of its starting, has been realised. My ideas regarding the syllabus have been justified by the inclusion of Book-keeping and Indian Currency and Finance among the subjects for the Indian examination. My hopes regarding the progress of the Institute have been fulfilled by the publication of such books as Mr. M. L. Tannan's Law

and Practice of Banking in India. In the other subjects of the examination, there are suitable text-books written from the Indian point of view. For Foreign Exchange, there is no such book and as part of a duty which I owe to the Institute for whose inception I was so much responsible, I have felt called upon to write one.

The subject of Foreign Exchange is one of those which could be aptly described in the words of Milton so well adapted by Charles Lamb to the case of a Lawyer friend, "Thou Great First Cause, least understood." The difficulties surrounding the acquisition of a correct working knowledge of the subject are various. No book can teach the subject thoroughly. The first-hand acquaintance with foreign exchange transactions, which is so essential to the understanding of the subject, is available to few banking employees in any country. Secondly, those who do have something to do with it acquire a few "rule of thumb" methods which cannot rank as principles, nor constitute a foundation for adaptation to varying conditions. Most of the professional economists in India have never come into real contact with it, basing their ideas on things they have gathered from sources whose authority is not above suspicion. The men who really know the subject have little time to write about it, and, perhaps, lack the aptitude to express themselves. When they get out of harness after all, they do not have the energy to write books, and it may even be that their ideas have become antiquated. In these circumstances, one has to be thankful that there are a few books dealing with the subject, with whose aid one can start with some hope of learning it.

The difficulty in the case of India is further increased by the fact that one has got to learn the subject, not by looking at the transactions from his end, but to put himself in the position of a man at the other end and, after understanding how it works there, he has to turn his mind inside out, give it a turn and a twist, stand on his head almost, to apply it to Indian conditions. It is, therefore, no wonder that the subject of Foreign Exchange is so little understood in India.

I have always been of opinion that no punishment could be severe enough for a person who wants to write a book and I was

never so surprised in my life as when I found that I had somehow got this form of madness. So far as I can understand it, the fault is not mine, but that of the trade depression which has forced me out of the banking world, temporarily I hope. If it is true that the devil finds mischief for idle hands to do, it is equally true that a trade depression is his right hand. And so it came about that, having nothing to do for some months, I decided to do my bit in lifting that depression.

I think I shall be justified in saying a few words about myself and my qualification for the task I have undertaken. The custom in such cases is to ask some great person to write a preface or foreword. But it often happens that he is in the same predicament as the Chairman referred to by Stephen Leacock who, in introducing the lecturer of the evening, stopped short twice, once to find out his name, and a second time, to find out the subject of the lecture. He, probably has the foreword written for him and signs it. I have thought it better to sign it myself.

When Mr. George W. Leman, representative of the Guaranty Trust Co. of New York came to India in 1920, to handle the large volume of our gold exports, a stenographer was required for him and I had the good luck to be selected. Mr. Leman did not take long to decide that he could make better use of my services and within three months, I had been transformed into his Personal Assistant, to work out his calculations, his gold and sterling parities, his dollar quotations and code his private cables to the Head Office. It sometimes happened that he told the brokers that I had authority to fix up a deal, which he would later formally confirm.

When the gold exports were over, The Guaranty Trust Co. tried to enter the silver market and conduct arbitrage operations between Bombay, Calcutta, London and New York. It had, however, to close its Bombay Office in 1922. I then entered the service of the American Express Co., Inc., where I was employed in several responsible positions in the banking department during a period of about eight years, holding the post of Accountant when I resigned in 1929 for health and domestic reasons. The recent Banking Enquiry gave me the

occasion and the opportunity to gather further detailed information regarding the handling of foreign exchange in India. When the Committee's sittings were over, I felt almost irresistibly forced to start writing this book, particularly as it seemed to be a sort of masonic secret about which its votaries would not give even the most meagre information.

It has been my aim to write the book so as to satisfy three kinds of readers. The first is the ordinary enquirer who wants to know what exactly upsets the people when an exchange rate goes down a point or goes up a point. Secondly, it is intended to be a text book for banking employees and students of the Commercial Colleges. Thirdly, it is intended to give the ordinary business-man some definite information as to what happens on the other side of the counter.

The book may be imperfect in several directions. It may not give information regarding several matters connected with foreign exchange in India ; but, like all first attempts, it has been a heavy task, though pleasant and even exhilarating. I hope that it will not be like Browning's "Sordello" about which a critic said that, after reading it, he did not know whether Sordello was a man, mountain or cloud.

There is a Tamil proverb which is so apt in this connection. It says that "For the crow, its young one has golden feathers." And there is the French proverb which has been a constant solace to me, "Un fou trouvait toujours un plus fou que l'admire", and this is true at least so far as my knowledge of foreign exchange is concerned.

There then remains the pleasant task of thanking those who have helped me. Some have helped in the preparation of the manuscript, some in reading over it, some in reading the proofs and some in giving me valuable suggestions. I would thank the Sri Gouranga Press and the Bengal Autotype Company for the very good work they have done with the printing and diagrams. I would also take the opportunity of thanking Viscount Kano for his kindness in discussing with me some aspects of the Japanese exchange in India.

In addition to the authors quoted in the body of the text, there are a good many others whom I have read with profit.

But a bibliography would seem to make invidious distinctions and I have refrained from giving one. Most of the ideas have been in my mind for several years ; but, when I found that they had already been expressed in books, I considered it better to go out of my way and quote them than be suspected of apparent plagiarism.

Above all, I must thank Mr. George W. Leman, who gave me the wonderful opportunity of starting the study of foreign exchange from what I may call its Mount Everest, and thus obtaining a thorough grasp of the prominent aspects of it, leaving the minor details to be worked out later ; and to the American Express Co. Inc. for the chance they gave me of studying these smaller details. I think it is fair to add that I would not have had this opportunity anywhere else in India.

I trust that the book will prove useful enough to those who have, for so long, been without even this little help. If it proves a success, it will be due as much to the rarity-value of the book, as to my own conscious efforts.

N. SANKARA AIYAR.

CALCUTTA,  
10th October, 1931.





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# FOREIGN EXCHANGE IN INDIA

## SECTION I.

### CHAPTER I.

#### MAINLY HISTORICAL.

*"He was versed in ancient lore"*

The Agency houses—The first exchange bank—The other exchange banks in India—They are all foreign—Naming of banks—Resources and working of foreign banks in India—Is exchange business risky?

Even before the earliest days of the East India Company, the foreign trade of India was carried on as a pure system of barter. The Indian seamen who went to other lands took with them spices and muslin and other Indian products of rare sorts and brought back in exchange goods of those countries such as oils, dates etc. The foreigners who themselves brought their own goods of value exchanged them for Indian products in the same way. Perhaps the ships which brought out the original goods went to other lands and exchanged some of them at least for the product of those lands and all these were exchanged in India. It was just like our sending goods to Germany and the United States to buy things from England.

In later days when the rupee became more standardised and it began to be well-known all over India, the exchange in India was effected in terms of the rupee and goods were bought and sold for rupees. The penetration of the agents of the East India Company into the interior made it possible for them to extend their operations over several centres where they erected factories for the purpose. These factories were used not only as trading centres but also as centres wherein to take refuge in times of unsettled political conditions.

Later on grew up the territorial activities of the Company and when it had fairly well established itself, it assisted various officials and servants to start agency companies to carry on the exchange operations connected with the trading rights and concessions of the East India Company. These agency houses were not only bankers in this sense but also traders on their own account. As the rupee was freely minted in India, its value was based on the price of silver and consequently the agency houses incurred occasional heavy losses particularly in 1829 to 1832 owing to the changes in the value of the rupee. Thus grew up the tradition that exchange banking was a risky business and that it was not wise for anyone to undertake it though its services were appreciated.

When the Presidency Banks were started and were granted the right of note issue, the custody of Government balances and the control of internal trade, it was contended, probably in view of the vested interests of the agency houses, that exchange banking was so very risky that these banks should not touch it with a pair of tongs. This theory was so widely accepted that it was regarded as a fundamental doctrine of the Company's policy.

Under the law as then existing, no company could be formed without unlimited liability of the directors unless it obtained a special charter from Parliament. If an unchartered bank were to be started to deal in exchange, it would have been necessary for all the partners to accept unlimited liability for its operations. This was not a popular way of promoting foreign banks but the obtaining of a charter involved so much log-rolling, so much of influence and so much of delay and red-tape-ism that it was generally several years before it was obtained and in the meantime it often happened that the original shareholders had lost all interest in the schemes or the promoters themselves had lost all their enthusiasm. Still several proposals were made to start such chartered banks but they were all turned down at the instance of the East India Company in India acting under the influence of the agency houses.

The first proposal to assume any shape was the famous Bank of India scheme of 1836 with a capital of £5 millions which

proposed to handle all Government business in India, to look after the remittances to England, to have the right to open branches all throughout India, in general to be what the Imperial Bank has now become and, in addition, to transact all kinds of exchange business. The Court of Directors in England was prepared to recommend the grant of the charter but the East India Company officials in India to whom it was referred were much against it, chiefly Financial Secretary Prinsep. It was contended that the exchange business was a specially risky one and it was unwise to allow an institution controlled from such a distance to assume such risks—because banking business everywhere required local direction—and the capital of five million pounds was considered hopelessly inadequate for the purpose! As for the government work it was being very well conducted by the Bank of Bengal and there was no necessity to allow another bank to start operations. In view of the opposition, the proposal was turned down though it was very influentially supported and several Indian agency houses had joined in the scheme. It turned out later that the scheme was a case of pure 'bluff' on the part of the agency houses to forestall any future proposals as the refusal of the charter to the Bank of India could be quoted to prevent grant of charters to them. If it was proposed to grant such charters, the Bank of India could claim priority and it would be only a combination of existing vested interests.

Another proposal in 1840 to form a chartered company with the resounding title "Bank of Asia" for the handling of exchange business in India was first turned down by the Court of Directors who remembered the Bank of India episode. Even though the promoters agreed to forego the right of doing exchange business in India and to confine these operations to other parts of Asia, the East India House claimed "China and the whole Eastern hemisphere from the Cape of Good Hope (including also Australasia) to the Straits of Magellan as territories within the jurisdiction of the East India Company." Finally the scheme was referred to India where the agency houses also joined in the opposition, and the scheme was buried unwept and unsung.

It was a matter of pure chance that a chartered company was able to get into this business. When the Bank of Ceylon operating in that Province with a charter was about to fail, the Bank of Western India of Bombay bought it up and applied for a continuation of the charter in the name of the Oriental Banking Corporation to operate in India, with a capital of £600,000. The Court of Directors, through oversight, forgot to refer the matter to India and recommended the grant of a charter, which was done, the chief factor being probably that it had already a charter for Ceylon. Too late it was discovered that an error had been committed. When the Chartered Bank of Asia (afterwards the Mercantile Bank of India) and the Chartered Bank of India, Australia and China applied for charters the matter was again referred to the Indian officials who refused to permit it.

It was then pointed out that the Oriental Banking Corporation had a charter and that if future charters were not permitted it would mean a virtual monopoly of the business to that company. Without conceding the argument, the Indian officials tried to side-track the issue by saying that the charter to the Oriental Banking Corporation could not have been properly given as the rights of trading east of Suez belonged by the original charter to the East India Company and no concession could be rightfully given to others to operate in this area without its consent. It was therefore proposed that the Oriental Banking Corporation should be morally debarred from starting operations in India. The latter however stood by its charter and the position began to assume a somewhat ridiculous aspect and the East India Company officials were on the horns of a dilemma. If they allowed the charter, they would be giving away their rights and if they refused it, they would be granting a virtual monopoly to a concern which, according to them, should never have been allowed to enter the business. Finally the charter was granted and thus started the formation of exchange banks to deal in Indian business. It was tragic that the Oriental Banking Corporation itself did not live long to enjoy the fruits of the rights it had thus acquired through "backstairs influence." The Chartered Bank of India,

Australia and China was also curiously enough, not allowed to enter Australia and is now confined to some countries in Asia.

Another type of exchange bank is the National Bank of India which was started in India in 1863 with Indian rupee capital and which at one time had three Indian directors out of seven. But the British shareholders found that their shares began to fluctuate with the value of the rupee, the bank transferred its headquarters to London in 1866 with sterling capital and the National Bank of India became the non-National Bank of non-India from that time. The advantages it gained through the access to the London market were incidental and the main object was to preserve the capital from depreciation.\*

Since 1850 several banks were started to carry on exchange business in India but they had all a more or less chequered career. The only one to leave a name behind was the Agra Bank which became the Agra and Masterman's Bank by amalgamation with a London concern—which finally brought about its downfall as in the case of the Alliance Bank of Simla. The Agra Bank has created many legal decisions on banking matters.

The open door that was maintained in India brought the Deutsche Asiatische Bank of Germany in 1896 and some other institutions which disappeared in the war-time. The Comptoir National d'Escompte de Paris, commonly known as the French Bank, the Eastern Bank which began working in 1909 and the International Banking Corporation entered in this period. The last named bank was purchased a few years ago by the National City Bank of New York and now works under that name. The place of the German bank was taken after the war by the Netherlands Trading Society (commonly known as the 'Trader') and the Netherlands India Commercial Bank (commonly referred to as the 'Dutchman'), which also look after the Java Trade.

The "Big Five" themselves tried to enter India and it

\* For much of this information I am indebted to Mr. A. S. J. Baster's "The Imperial Banks."



was proposed at one time that Lloyds Bank should acquire the National Bank of India but the British Treasury vetoed the scheme and it was the imminence of the arrival of such a big competitor that made the Presidency Banks amalgamate as the Imperial Bank of India. Lloyds Bank, however, was not to be denied and it bought up King and Co. and the Indian business of Cox and Co. (the French business being acquired by Lloyds and National Provincial Foreign Bank). It has now several branches in the interior in addition to the port towns. The P. & O. Banking Corporation started by Lord Inchcape made its entry into India in April 1920 and almost immediately after, it acquired the Allahabad Bank controlling interest and Lord Inchcape boasted that his concern had acquired a valuable foothold in inland business which was more remunerative than the exchange business. The victory was short-lived as his bank was itself bought up by the Chartered Bank of India which has thus a controlling interest over inland business in no less than 35 centres in the interior and deposits of about eleven crores.

The Japanese banks are the Yokohama Specie Bank, the Sumitomo Bank and the Bank of Taiwan but the latter two have much less business than the former. The Mitsui Bank which is one of the "Big Five" in Japan could not make any headway against them in India and retired from the field. These banks handle the Chinese business which they share with the British banks, the chief of which is the Hongkong and Shanghai Banking Corporation which also has some business with the Straits Settlements and London.

There are also the minor banks like the Banco Nacional Ultramarino dealing with Portuguese interests in Goa and the Imperial Bank of Persia chiefly concerned with Persia. There are also the tourist agencies such as Thos. Cook and Son (Bankers) and the American Express Company Inc. which tried to enter the regular exchange business but had to retire from that line.

It is an irony that all the banks in India which have monopolised the use of the country's name are more or less foreign ones. To start with we have seen that the National Bank of

India is no more "national" for India than the National City Bank of New York and as Mr. Spalding still calls Indian authors "native writers," the National Bank of India has been using its name down to 1931. Then come the Mercantile Bank of India and the Chartered Bank of India, both foreign banks. Then we have the Imperial Bank of India which is manned by Europeans in the superior grades and which is believed to care more for European clients than for Indians.\* Its shares are held up to 51% by Europeans and its loans are, proportionately to deposits, more to them than to Indians. Its officials in the port towns are all European in the important posts, so that if the Imperial Bank of India should start into the exchange business, it will be no more national than the National Bank of India itself. The charm has spread even to domestic banks like the "Bank of India."

Like the Indian commercial bodies which have to call themselves Burma Indian Chamber of Commerce and the Bengal National Chamber of Commerce because the titles "Burma Chamber of Commerce" and "Bengal Chamber of Commerce" had already been appropriated by almost exclusive European associations, the new currency authority proposed for India has to call itself the "Reserve Bank of India" instead of the "National Bank of India" which has been usurped by a foreign bank. The Reserve Bank in fact finds all the eligible names already used up. There is already an Imperial Bank of India, a National Bank of India, an Indian Bank, a Bank of India, a Central Bank of India, a Peoples' Bank of India, a Chartered Bank of India and it is lucky for the Reserve Bank of India that no one thought of adopting that name.

The exchange banks have always adhered to the theory that their business was very risky and they made the Government of India drop the proposal of 1904 to permit the Presidency Banks to borrow in London in times of stringency, though they themselves did not help at such times by bringing out money. At one time indeed they calmly allowed a crisis to develop and even the Government of India were moved to protest

\* Evidence before the Central Banking Enquiry Committee

against their indifference. The Imperial Bank of India was also placed under this disability because of the attitude of the exchange banks and thus the nemesis of the Company's attitude towards the chartered companies of the thirties of the last century struck its own institutions and the Imperial Bank of India is yet to be free to enter exchange business.

It would appear that exchange business is not so very risky as it is made out to be. In the first place the failures among the exchange banks have not been as high as the failures among banks dealing in internal trade. Secondly the people of India do not take them seriously, nor would they themselves desire to be taken so. The Imperial Bank of India with its 170 branches cannot command more desposits than the exchange banks mainly confined to the port towns and if we take the Allahabad Bank as a foreign bank, the total deposits of the latter are about ten crores more than the Imperial Bank of India. This trust of Indian clients indicates that in their opinion, exchange business is less risky.

The importance of the exchange banks lies not so much in the actual profits they make as in the *national* service they perform and it is this aspect of the question which is emphasised by the establishment in India of banks representating the chief customers of India. The foreign trade returns of India show that our chief business is with England, Germany, the United States, Japan and the Latin countries. All these are represented here by full-fledged branches of important concerns. The Germans are represented by the Dutch banks which are culturally allied to them as the Italian and Belgian interests are represented by the French bank.

Some idea of the amount of business transacted by these banks and the funds with which they transact them can be obtained from a consolidated balance sheet of the foreign banks as of March 1930. This statement was obtained after a good deal of delay and circumlocution by the Central Banking Committee\* but it is important as giving for the first time some idea of the position of these banks. The Indian law

\* Appendix to Mr. Manu Subedar's Minority Report, Central Banking Enquiry Committee.

# MAINLY HISTORICAL

permits a bank to operate in the country without furnishing any return of its financial operations here so long as it is a foreign institution. Mr. N. R. Sarker in his note of dissent gives these figures for the British and non-British banks and the remarks which he makes in this connection are illuminating as indicating their business methods.

*Table 1. Balance sheet of foreign banks in India—March 1930.*

*Current Accounts and Call Money.*

Non-Indian	British Banks	...	13		
	Other Banks	...	2	15	
Indian	British Banks	...	17		
	Other Banks	...	2	19	34

*Fixed and Short Deposits.*

Non-Indian	British Banks	...	9		
	Other Banks	...	3	12	
Indian	British Banks	...	18		
	Other Banks	...	2	20	32

*Outstanding Loans etc. outside India.*

British Banks	...	16		
Other Banks	...	6	22	22

*Total* ... .. 88 crores

• Total non-Indian Deposits ... 27 crores.

Total Indian Deposits ... 39 crores.

*Advances in India.*

Non-Indian	British Banks	...	11		
	Other Banks	...	4	15	
Indian	British Banks	...	26		
	Other Banks	...	5	31	46

*Investment in securities.*

British Banks	...	24		
Other Banks	...	2	26	26

*Bills of Exchange in Transit.*

British Banks	...	7		
Other Banks	...	3	10	10

*Cash and other assets.*

British Banks	...	5		
Other Banks	...	1	6	6

*Total* ... .. 88 crores.

"16. The figures also indicate a difference in the practice of British and non-British banks. The former have invested seven crores of Indian deposits for buying bills of exchange but non-British banks

use three crores of their own money for the same purpose. In other words British banks with deposits of 57 crores, have advanced 37 crores in India and maintain cash and other assets 5 crores, having invested the balance in securities and bills of exchange. The non-British banks with deposits of nine crores have lent the whole of it in this country.

"17. It will be seen that the British banks have not borrowed in London or elsewhere for their operations in India. Though they have loans etc., outstanding abroad to the extent of 16 crores, they hold securities for 24 crores in India. In other words, the foreign loans really represent investments of foreigners in Indian Treasury Bills. In the case of the non-British banks, on the other hand, the foreign loans amount to six crores while the value of their securities investment is only two crores; that is they use about four crores of their own money in India, while the British banks have large amounts of unusable deposits which have led them to invest as much as eight crores in Treasury Bills. It is evident, therefore, that on balance the British banks do not have to bring money from abroad."

Exchange business is certainly a risky one, in the sense that, like all business, success is achieved only by the experts. It is not enough to have sufficient funds at one's disposal. It is not enough to have access to the London Market (about which so much is being made); it is not enough to have extensive clientele. The most important thing is to have capable exchange operators. It is rumoured that an Indian bank which heard of this put on its telephone exchange operator on the job and had to face heavy losses. The next important thing is to work with local deposits. The exchange banks make a success of their work chiefly because they have access to cheap money in India. The average cost to them is about 3% or even less, though in times of stringency they have to borrow call money at 5, 6 and even 7%. This only shows that even at such high rates for money, there is some profit to be made, as the exchange banks are not here for their health, as the Chinese would say.

The importance of the Indian funds is illustrated by the tragic failure of a foreign concern which decided to enter the exchange field. The exchange operator thought that the only thing was to buy up all the bills or make contracts for their purchase, and sell the sterling at the proper time. His total resources in India were not over three lakhs of current accounts and ten lakhs of overdraft with a bank. His total London

resources were an overdraft of £10,000 to £20,000 with his London office. And yet he thought he could buy all the bills in one of the port towns. He certainly was able to do so, so long as his rates were as good as those of the other banks though sometimes he had to go slightly better. He could sell the cable transfer for the approximate deliveries as well as the other banks and perhaps the fact that he had cornered the bill market gave him a slight command of the position. But the day of reckoning came all too soon. He had shown very good profits when he made his contracts but he had not counted on a rise in the London discount rate, which took away all the profits. He found the bills were late and his Indian resources were overflowing because the cable transfers were being taken up too soon. This meant a heavy overdraft with his London Office which sent out frantic messages to him to reduce it. He had to buy ready sterling and sell forward to meet the situation and had to take a loss on the transaction in addition to having to pay brokerage on the sales. Then came his bill clients too early with their documents. He had no money. He used up his local overdraft and yet the bills came. He had to reverse his position and sell ready and buy forward and incur further losses through payments of brokerage and discounts on forward exchange. He stopped making contracts for bills, his brokers did not call as often and he was glad to get out of the mess in the course of a year. In the meantime the expected profit of some lakhs was transformed into a real loss of several lakhs. Wounded and bruised, with fingers scorched and scarred, he retired from the field and thanked his stars that the volume of foreign trade of India was only 300 crores as he might otherwise have bought much more and faced more heavy losses.

Another aspirant for the honours tried to work on the theory that he had only to buy enough to be able to command his price. He had no London office and his resources in India were unlimited so far as his needs were concerned. He did buy all he wanted but he could not sell because it chanced to be a year of large surplus exports and he was landed with all the surplus bills. Finally he found that he had to sell and

sell at the price demanded by those who had had enough. He felt that it was hard luck.

All this does not show that exchange banking is risky but that, like all trades and professions, an arduous period of apprenticeship has to be gone through. The success of the exchange banker does not depend on the size and comfort of his desk and chair but on the work he has done in acquiring the details and the clearness with which he has grasped the intricacies of the working of the exchange market. It is true that no one can learn to swim without entering the water but it is also true that the help of an expert in natation would be of great value in minimising the risk of drowning and that final success depends on the ability to take the risk and progress should be through shallow waters into the blue depths. A pair of wings in the form of a foreign expert might be useful but it may be found that when the wings have gone the capacity to float has also gone.

It is difficult to acquire this experience from other banks as for various reasons the foreign banks have not trained one Indian to assume charge of exchange business. As a writer recently put it in the "Indian Review":—

"In spite of about seventy years of life in India, they have not yet found one solitary Indian whom they could trust with any responsible work. No opportunities exist for Indians to learn anything about the operations of the exchange market and their position has been merely that of a worker in the Detroit Factory who is employed in turning out numberless screws of the specification No. 1743. What it is for and what part it plays in the final assembling of the car he does not know. Instances would not be difficult to find of men who have started like the famous John Smith of Stephen Leacock and ended like him."

The barrier against Indians in other countries must be equally, if not more, effective ; for, if banks operating in India will not give some Indians at least a sound training in the various branches of the business, what are the chances of a bank in other countries giving them the chance of learning it all? And it is a fact that experience in other countries is of little avail for Indian exchange operations. It is this which has resulted in some difficulties in the path of non-British bankers in India but they have set out to learn the business at any cost and have lived through.

Indian banks which wish to enter the exchange field may therefore well take to heart the lesson of the Sanskrit verse which is very apt in this connection :—

The worst are they who ne'er begin  
 For fear perchance they also fail;  
 The better men are they who cease  
 When dangers cross the way they trail;  
 The best are they who ne'er retreat  
 Though dangers thick around them hail.

(Bhartṛhari, Nitisataka).

## CHAPTER II.

### THE FOREIGN TRADE OF INDIA

*"So Hiram gave Solomon cedar trees and fir trees and Solomon gave Hiram wheat and pure oil"*

The growth of our foreign trade—Seasonal variations in trade movements—Main exports and imports—The port traffic—Our customers—Customs duties

The foreign trade of India has been growing very rapidly during the last three decades. The following statistics of the trade in and out of India shows the rate at which it has grown, and the extent to which our foreign trade has come to dominate our domestic markets, and the consequent importance of the foreign exchange question :—

Table 2 :—*Growth of foreign trade of India, 1868—1931.*

Year (in crores).	Exports of merchandise.	I M P O R T S.			
		Merchandise.	Treasure.	Invisible.	Total.
1868-69 ...	55	30	17	8	110
1878-79 ...	61	39	10	12	122
1888-89 ...	89	59	13	17	178
1898-99 ...	108	70	12	26	216
1908-09 ...	165	117	21	27	330
1913-14 ...	225	151	37	37	450
1918-19 ...	302	249	26	27	604
1924-25 ...	398	243	94	61	796
1929-30 ...	318	251	34	33	636
1930-31 ...	226	165	24	37	452



The year 1930-31 was the year in which trade depression all the world over combined with the boycott movement of Mahatma Gandhi to restrict our foreign trade. Signs of revival are as yet absent as our customers have not yet recovered from the effects of the depression which has hit every nation.

The movement of commodities in the various months of the year are shown in the graph below :—

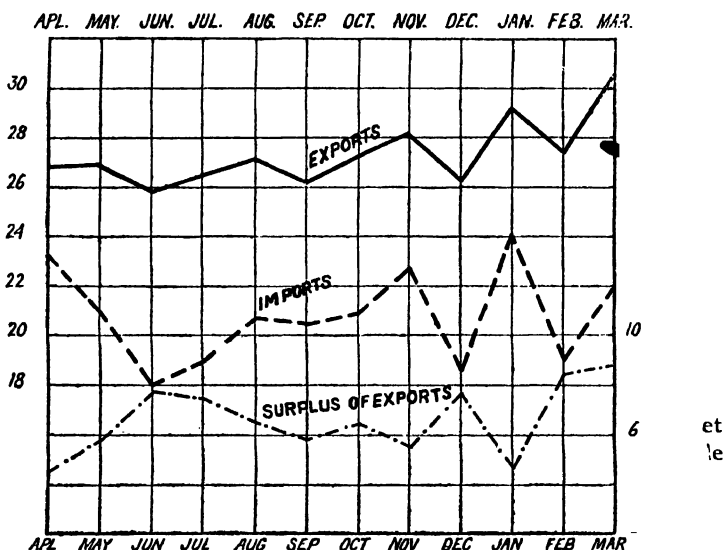


Diagram 1. Monthly average of exports and imports for 1927-28, 1928-29, and 1929-30.

The graph shows that imports reach a low level in June and a high level in January with another low level in February. The reason for the last mentioned change is probably that the budget of the new year becomes operative from the first of March and people import in large quantities before early February to escape the new taxes. Exports on the other hand are highest in March, low from April to December and then begin to move up with a further fall in February. There is thus a favourable balance of trade every month with a maximum in

March and a secondary maximum in June owing to fall in imports and a minimum in January.

The chief commodities of export and import are shown in pictorial form below in order of their importance. Imports come equally into Bombay and Calcutta (which is fast losing its importance as the first city in India, the latest census shows the population of the two cities to be nearly equal) though exports are in larger volume through Calcutta than Bombay. The other ports are Madras, Karachi and Rangoon in order of importance:—

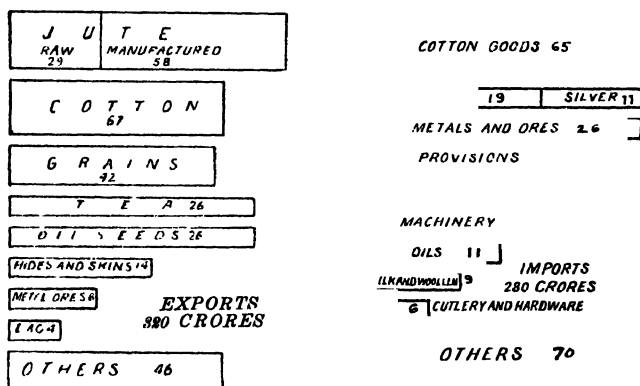


Diagram 2. Exports and Imports—Commodities.

Jute and tea go through Calcutta, cotton through Bombay mostly, though the Madras production moves through that port. Rice, mostly from Burma, moves through Rangoon and wheat from the Punjab through Karachi though the United Provinces production goes through Bombay. Seeds mostly go through Madras as also hides and skins, and metals and ores from Calcutta and Bombay. Among imports cotton piecegoods come through Calcutta, Bombay and Karachi. Most of the bullion comes in through Bombay with Madras and Calcutta as good bonds. Metals and ores come in through Calcutta and Bombay and sugar through Calcutta, Bombay and Karachi. Cutlery and hardware come in through Bombay and Calcutta also silk and woollen goods.

The following diagrams show the volume of our trade with our customers :—

EXPORTS  
320 CRORES



IMPORTS  
280 CRORES



Diagram 3. Exports and Imports—Countries.

Jute is bought as raw chiefly by Germany, Britain, France, the United States and Italy. For gunny bags our best buyers are Australia, Britain, Java and China. The United States absorb most of the gunny cloth. Jute requires financing from July to October. Japan is the best customer of cotton with Italy, China, Germany, Belgium, Britain and France coming in the wake. Cotton moves in October and requires financing from then to February. Rice goes chiefly to Ceylon, Germany, Straits Settlements and Africa. To most countries it goes as food product but to Germany it is for glue manufacture etc. The export of rice being from Burma is independent of the monsoon but a famine in India will bring the Burma crop to India and foreigners will find that they cannot afford to give the price which India can pay to tempt Rangoon. Rice moves in January mostly. Wheat is harvested in May and reaches the European ports in July to September and supplements the Australian and American wheat. After the War Indian exports of wheat have fallen down considerably and it has even been imported in some years, the chief reason being probably that Punjab wheat is unable to compete with

Australian wheat which, at the same price level, has the advantage of cheaper freight by steamer than Punjab wheat over the railways of India. Oilseeds go to France, Germany, Italy, Britain, Netherlands and Belgium. Tea goes chiefly to the United Kingdom. Hides and Skins go to the United States and Britain; and the German share in this trade has recently shown a declining tendency. Metal ores go mostly to France, Britain, Belgium, Holland and the United States.

Among imports cotton manufactures from England are being steadily replaced by Japanese goods which in 1929-30, the year before the boycott started, had captured nearly 30% of the total imports. Raw cotton comes in from Kenya, Egypt and sometimes from the United States. Gold comes in from South Africa and Australia directly and through London and silver from the United States and the Continent through London. Iron and steel are imported mostly from Britain and from Belgium; and copper, brass etc. from Germany, France and Belgium. Machinery are mostly from the United Kingdom while it shares with Germany the cutlery and hardware trade. Sugar comes in mostly from Java, silk goods from China and Japan, and woollens from Britain, France and Italy.

There is a revenue duty on hides and skins exports of 5% ad valorem; specific duties equal to 1% on rice, 6% on raw jute and 4½% on manufactured jute. On imports there are protective duties of 17% on iron and steel, 15% on paper, 20 to 25% on textiles, 120% on matches. There are also non-protective duties of 2½% on printing materials and wood; 10% on metal ores, cutlery, railway plant, iron and steel ingots, bars, rods etc.; 15% on provisions, oils, silk, apparel, military stores, machines, hardware, instruments, dyes, glassware, machinery, yarns and textiles; 20% on motor vehicles; 30% on articles of luxury such as clocks, musical instruments, arms and ammunition, gold manufactures, silk piecegoods; and 75% on cigars. During the current year, special surcharges have been added to some of these duties to meet the budget deficits and new duties have also been added on salt and wheat and an additional jute

cess on exports. Owing to the low price of silver a duty of four annas per ounce which had been in abeyance for some years was levied, which has been increased to six annas this year. *If the goods are re-exported within two years and can be identified, a refund of the duty up to seven-eighths of the amount paid is allowed as "drawback".*

From May 15th to August 15th is a very slack period owing to the monsoon or seasonal rainy weather. It is this which determines whether the year shall be one of plenty or of famine and whether the Government's budget will be ultimately one of deficit or of surplus. During the monsoon commodities do not move owing to the risk in moving them about. In some parts of India it becomes literally true that it never rains but it pours and there is not probably a single day in July or August on which goods could safely be removed within a city. The markets are dull and money is not in demand so that sometimes call money is unlendable. The cash balance of the Imperial Bank of India rises up like the thermometer in mid-April and the trade demand goes down like it in December. Along with others the Imperial Bank of India seeks the securities market and there is a seasonal bullish demand for securities to be followed by a selling movement in November when trade begins to be brisk.

The busy season starts in October and ends with February but the liquidation of money demand does not stop then but continues well into March and the bank rate does not go down till April. In October, prospective business in exports and imports can be fairly assessed and the exporters and importers make their contracts with the banks and with the traders in other countries. Movements of commodities begin to be active and the banks become busy again.

India having no mercantile marine has to pay freight to other countries both for her exports and her imports. Allowing other countries the right to freight on one movement, we find that on our exports we pay freight of about £8½ millions on 7½ million tons of goods just as on the insurance business we pay nearly 60 lakhs of rupees on 300

crores. Judged by the tonnage of the vessels cleared, the following are the freight amounts we pay to other countries :—

*Table 3. Freight paid to foreign shipping.*

British vessels	...	Rs. 7·7 crores.
German „	...	„ 0·7 „
Japanese „	...	„ 0·6 „
Italian „	...	„ 0·6 „
Dutch „	...	„ 0·5 „
U. S. A. „	...	„ 0·3 „
French „	...	„ 0·2 „
Norwegian „	...	„ 0·2 „
Other vessels	...	„ 0·3 „

Total ... Rs. 11·0 crores.

## CHAPTER III.

### THE CAREER OF A FOREIGN TRADE MOVEMENT.

*“We come nearer to the golden gates”*

Who finances an export movement—Who finances from port to port—Who finances an import movement—Foreign banks in import trade—Mr. Spalding's Marwari—If it were only true.

When a commodity moves from one country to another, there are three distinct stages in the movement which should be recognised. The first stage is the assembling of the goods up to the time of the shipment. The second stage is the transit from port to port. The third stage is the distribution in the importing country from the time of arrival. The first stage of the business is usually deemed to be the work of domestic banks. The second stage is considered to be a matter of international trade and the field of banks engaged more or less exclusively in that work. But there is a tacit understanding that the movements must be financed by banks belonging to either the exporting or the importing country. In the third

stage again, the domestic banks come in for financing it. These are illustrated in the diagram below :—

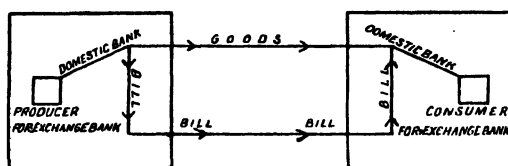


Diagram 4. Story of a foreign trade movement.

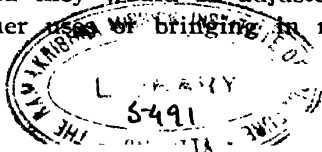
Up to the time of shipment of the goods, the shippers resort to the domestic banks for loans to purchase or manufacture the goods, or the banks sometimes lend their credit to enable them to borrow in the local discount market. If the purchaser or manufacturer has the goods in a form ready for export but awaiting shipment, it may be sometimes possible to have the accommodation from an exchange bank because an agreement is usually made that the documents when ready will be delivered to the bank so that their value may be set off against the loans.

The movement from port to port may be financed by the exchange banks and for this purpose they use their own funds and credit. If the bank belongs to the exporting country, the funds in the last resort come from that country and if it belongs to the importing country the funds in the last resort come from it. It sometimes happens that the commodity is sold in terms of the currency of a third country and, in this case, apart from purchasing, forwarding and clearing the documents, the exchange banks do not have the actual financing of the goods, which is done by the intermediary country.

In the third stage, as soon as documents arrive in the importing country, the business of the foreign banks stops. It then becomes the work of the local banks to advance money to the importers to obtain control over the documents or to extend credit to enable them to borrow in the local discount market. The business of the foreign banks or their agents would end with having the importer pay for the documents or undertake to pay for them at a later date if so permitted.

This division of stages in the movement of a commodity has been recognised by several authorities and the practice in most countries is in accordance with this idea. It sometimes happened, however, as in the case of India, that banks for foreign trade were organised much earlier than banks for local trade. Consequently the first stage of exports from India and the last stage of the imports into India had, for a long time, to be handled by these foreign banks by extending their operations into domains not usually considered theirs. As a result the British banks in India who for several years had a monopoly of this business have been making advances to exporters and loans to importers in connection with the domestic side of the business. For some time some of them tried to use their own funds. But in view of the rather violent fluctuations in the value of the rupee which was then being freely minted against tenders of silver bullion, the banks were unwilling to risk the possibility of depreciation of their capital for the sake of a possible small gain in exchange profits. The exchange banks then developed internal deposits to a very large extent with the result that the British banks alone now possess about 56 crores of deposits which they utilise for buying bills on foreign countries, for making advances to exporters and importers and in fact to transact all business connected with the foreign trade of India except that the locking of money in London for two or three weeks purchase of bills *on India* is done by the London offices with their own money.

It is not the sphere of a book of this kind to enquire into the possibility of transferring this business to Indian banks for national or sentimental reasons. But from the point of view of the harmonious working of the monetary organisation of the country, it may be pointed out that this system has resulted in a concentration of deposits in the hands of the exchange banks instead of their being mobilised for lending directly to the parties concerned, as happens in other countries. An efficient discount market could utilise its funds in foreign trade just as much as it calls for and if there are variations in the demand they would be adjusted by turning the spare money to other ~~uses of bringing in~~ new money temporarily.



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The exchange banks, on the other hand, have enough deposits to carry them through in ordinary seasons, with the result that in the slack season they have several crores of money without an outlet, and they often send out the funds temporarily and in the busy season they require fresh money which they borrow from the local banks or call out fresh deposits by offering better terms. They sometimes bring out their own money from London for short periods.

Mr. Spalding in his "Finance of Foreign Trade" writes as follows:—

"The Marwari or native bankers are principally concerned with the financing of the inland trade of India; they, so to speak, take their quota of profit before the exchange banks come on the scene. . . . . The Marwaris are well known to the exchange banks who make them advances or make exchange contracts with them from time to time. In short, it is the Marwari's business to raise funds from the exchange banks on security, and to utilise those funds in the finance of imports and exports to and from the interior. The Marwari is, in effect, the middleman in Indian trade finance; his role is akin to that of the London joint stock banks who finance the wares of merchants and manufacturers *up to the time of shipment, when the exchange banker comes on the scene.*" (The italics are mine).

This is a very incorrect statement of the case in India and it is a pity that Mr. Spalding who has had considerable experience in China and is generally so well-informed and has written so many authoritative books on foreign exchange, should have taken this "fairy tale" from some retired Bombay banker. Once such a story gets into a book of this kind, it circulates and is so often quoted that by the time it gets back to the author, he begins to believe that it is perfectly true.

In the first place, though the Marwari is fast spreading his influence all over India like the Jews over Europe and the rest of the world, he has at least three types of rivals. There are the Multanis who have gone out into the bigger cities of India and even abroad and whose clannishness is only equalled by that of the Scotch and is as potent as that of the Marwari himself. He also enjoys better facilities from the Imperial Bank of India.\* Then come the Nattukottai Chettiyars of Southern India who are bankers *in excelsis* in that area and

\*Madras Banking Committee Report p. 191.

who have established themselves in Burma, Malaya and Java.\* Then come the local businessmen like the Bhagyakul family of Bengal, the Bhargavas of the United Provinces etc. who do not belong to any special clan.

Secondly the Marwaris do not enjoy such credit from the exchange banks. They do not borrow generally and they have only bills as collateral and these are not generally considered by the banks as sufficient security.† In any case their operations do not relate to foreign trade so much as to domestic trade as such. Most of them have their own funds and some accept deposits from the public also.‡

Thirdly the foreign trade of India is at least 80% in the hands of foreigners§ and they can obtain advances from the exchange banks both for buying goods from the interior and for moving imports into the country. Even where Indians have this business they have also direct access to these banks which lend even for internal trade to some extent.||

Fourthly the exchange banks have the help and co-operation of the Imperial Bank of India with its 170 branches and also the services of the affiliate Allahabad Bank which is owned by the Chartered Bank of India through its control of the P. & O. Banking Corporation. The inward movement and outward movement of goods are financed through these agencies as far as the exchange banks can influence the business. The exchange banks themselves have branches in such important centres as Delhi, Amritsar, Lahore and Cawnpore.

Fifthly in all the important cities there are several Indian banks and one or two in the smaller towns and these give all the financial assistance necessary for such movements.

Sixthly, it was complained before the Central Banking Committee that European houses had now more or less dis-

\* Curiously enough Mr. Spalding in his "Eastern Currency and Finance" refers to them as the 'Natta-Kottai and the Chetties' as if they were two separate classes of people, while Nattukottai is an adjective as in "German Jew" or "Highland Scot."

† Evidence of Mr. MacDonald, Managing Governor of the Imperial Bank of India, before the Central Banking Enquiry Committee.

‡ Madras Banking Committee Report page 188.

§ Statement placed before the Central Banking Committee by the Indian Chamber of Commerce, Calcutta.

|| Punjab Banking Committee Report, para 106.

pensed with the services of Indian agents such as Dubashes, *Banyans and brokers for operations in the important buying and selling centres and that the Indian share of the business is now confined to the insignificant work of the movement of the goods between the smaller towns and the villages.*

Lastly the Marwaris or to be more correct, the indigenous bankers have lost so much business that, as the Central Banking Committee point out, several of them have had to take to trading or have combined trading with banking and one of the most important recommendations of the Committee is about organising them and bringing them into line with the banking money market through association with the Reserve Bank when it is started. Their decline is attributed to their following old styles of accounting and handling business but it is well known that among the Chettiyars and Multanis there is not so much decline in business. The reason is that, in the areas where they thrive, Indians still have a large inland business which is their mainstay as in the old days; but in Northern India, which is the main domain of the Marwari, the foreign trade of Indians has rapidly declined and with it the fortunes of the Marwari.

The principle as enunciated by Mr. Spalding would be a sound one if it were true in practice. The exchange banker should, as he says, appear on the scene when the shipment has been made and he should similarly disappear from the scene when the goods have reached the port. It is to be hoped that the convention will be observed hereafter at least, that the Indian banks and bankers will have the financing of the internal trade movements and that the exchange banks will concern themselves with the foreign trade movements from port to port. It may be pertinent in this connection to refer to the theory accepted by the International Conference on the Treatment of Foreigners that freedom of movement for foreigners is for the purposes of international trade only and that nations have the right to restrict their freedom in regard to internal trade.

In actual practice, the exchange banks use a good part of their 66 crores of deposits in lending to people dealing in trade connected with exports and imports. Some of these deposits

are from current accounts at 2 per cent. and some are *fixed deposits* at 4 per cent. average. Even assuming that the *fixed deposits* are equal to the current accounts, this would give an average rate of 3 per cent. or nearly two crores of interest payable. After allowing for ten crores locked up in bills and five crores of idle money as cash, there is about 50 crores lent out and invested in securities, the former at well above 6% and the latter at about 5%. The interest earnings are thus nearly 290 lakhs and the net profit is about 90 lakhs which, if Mr. Spalding's statement were correct, would have been earned by Indian banks and bankers. The Central Banking Committee, however, have not made any suggestions in this regard as they deem it proper that the existing order of things should not be disturbed.

## CHAPTER IV.

### THE BALANCE OF TRADE.

*"Weighed and found wanting"*

What is balance of trade—The mercantilists—The classical school—The modern school—Balance of payments—Visible and invisible exports and imports—Balance of trade of India—of Britain, United States and Japan.

The theory of foreign trade that held supreme sway for several generations was what is known as the mercantilist theory which stated that if you export sufficiently large volume of goods and import as little as possible, the difference between exports and imports is bound to be settled by inflow of gold, which, according to them, was the object to be achieved by foreign trade. The followers of this doctrine therefore made every effort to increase the exports and curtail imports. But it often happened that there was a tendency for gold to move out of the country and this was tried to be got over by prohibition of exports of gold. In those days gold was circulating in most countries as coin and as there came about a prohibition of exports of gold coins, they gradually acquired a high value in terms of other coins and according to Gresham's Law the

better coins were driven out of circulation by the inferior ones. There was also illicit export of gold on account of the premium it commanded in other countries at such times. 10

The mercantilist was a protectionist and believed in meeting the demands of the nation from within the country also so that the exports were to be confined to the surplus production and imports limited to the minimum required by the fact of the goods not being available within the country. He believed that the accretions of gold through the exporting of goods was an object for the achievement of which the efforts of the nation should be concentrated. 11

Until the close of the eighteenth century this theory held full sway and even to-day it has not ceased to be a living idea. It is seen in the persistent efforts of all nations to have 'favourable' balances of trade and discourage imports by all possible means while encouraging exports by special concessions. It may not be that the efforts are successful but when a country like the United States to which huge sums are due year after year for interest on investments builds up a tremendous tariff wall to keep out foreign manufactures, it is clear that other countries can only pay up their dues to the United States by purchasing the <sup>and</sup> supplies that are available and shipping them to that country, or by borrowing further from the creditor—a new way to pay old debts—both of which are harmful in their results. If the borrowing goes on to pay old debts and even the interest on them, it does not require a very vivid imagination to see that they must soon become bankrupt.

The theory that is now openly adhered to generally is what is known as the classical theory which believes that the steady promotion and growth of international trade and commerce is beneficial to all parties. As Adam Smith put it:—

"Foreign trade carries out that surplus part of the produce of their land and labour for which there is no demand among them and brings back in return for it something else for which there is a demand. It gives a value to superfluities by exchanging them for something else which may satisfy a part of their wants and increase their enjoyments. By means of it, the narrowness of the home market does not hinder the division of labour in any particular branch of art from being carried to the highest perfection."

*Foreign trade thus extends the territorial division of labour* to the whole world and each country produces those goods for which it is naturally fitted and exports the surplus beyond the country's needs and receives in exchange those of the commodities produced by other nations which it needs. Countries therefore have a tendency to become either predominantly agricultural or manufacturing. The result is that the agriculturist looks with jealousy at the ease with which manufacturing countries create some flimsy article or other and take away the hard earned wages of his labour while the manufacturing country bemoans its fate which makes it depend for its food on the goodwill of other nations. It has to pray that the other countries should flourish and should have surplus produce to export. It has to be jealous about international peace as any danger to communications would cut off its food supplies and thus the habit of 'policing the world' comes in. The process of division of labour may also go too far and each country, instead of depending on several lines of manufacture, concentrates and specialises in one or a limited few with the result that the slump in one of them produces heavy suffering on it and reacts on other countries.

The latest theory is what is called as Purchasing Power Parity theory, but as it is not likely that the beginner will find it easy to follow it through and also because of the limitations of the theory, a description and discussion of it is postponed to the third section. The conscientious student can, after reading that portion, start on the course again and see how far the theory works itself out in practice. One of the best books studying foreign exchange on the basis of this theory is S. E. Thomas' "Principles and Arithmetic of Foreign Exchange" which the reader could profitably peruse.

The mercantilist is a believer in protection and tariffs but the classical man believes in free trade and easy means of international commerce. The mercantilist school saw advantage only in a definite tangible surplus of exports, but the classical school believed that so long as something was received in exchange for goods all was well. For them trade embraced

the rights to capital and the buying and selling of services to other nations.

In modern times therefore the tendency is to balance not exports and imports of merchandise only, but all exports and all imports, the additional items being denoted as invisible exports and invisible imports. Hence a surplus of exports does not mean an influx of gold to that extent. India is one of the best examples of a country having to export a heavy proportion of its produce for the "services" of foreigners. The sum total of these invisible exports is seen from the fact that though the total of goods exported in 1928/29 was 338 crores and imports were only 251 crores, the amount of gold and silver imported was only 34 crores, 53 crores being used up for services.

The true balance of trade should therefore be the balance of payments and should include all the visible items such as merchandise, gold and silver etc., and should also include all the invisible items. The constituents of the correct balance of trade are thus summarised :—

#### *Supply of Exchange*

##### I. Trade Influences

Exports of produce  
Exports of gold and silver  
Freight and insurance

##### II. Loan operations

Loans floated by us abroad  
Loans repaid to us  
Interest due to us  
Investment of foreigners in internal loans  
Investment of foreigners in the country

##### III. Banking influences

Travellers' expenses  
Arbitrage operations

#### *Demand for Exchange*

##### I. Trade influences

Imports of merchandise  
Imports of silver and gold  
Freight and insurance

##### II. Loan operations

Loans repaid by us abroad  
Loans made to foreigners  
Interest on loans abroad

Interest to foreigners on internal loans  
Dividends of foreign investments  
Return of foreign investments

III. Banking influences

Credits for travellers  
Arbitrage operations

IV. Government transactions.

When the Government of India, for its capital expenditure or unforeseen shortage in revenues or on account of the difficulty of meeting the Secretary of State's requirements, floats a loan in London against the security of its general revenues, it thereby acquires the right to the sterling value of this loan and, to this extent it is as if it had exported its securities abroad as commodity. But when the loans have to be repaid, there will have to be created the same amount of demand for foreign currencies. The Government also floats loans in India for capital and other requirements. In such cases if the interest rate is sufficiently high and the loan is short dated, it often becomes possible for foreigners to bring money into India for investment and take it back when the loans fall due, thus making a better return on the funds than if invested abroad. This creates a supply of exchange but it also creates a future demand for it.

Arbitrage is the method of selling one currency to obtain another. Usually on account of the fluidity of bankers' funds between one centre and another this is a very important item in international transactions. In India due to the fact that money is more or less permanently invested, this type of operations is not very common. But there is an allied form of arbitrage, the bullion arbitrage, which is quite common. Usually India imports gold and silver but it does happen that gold and silver are exported as in the years 1920, 1921 and 1922 when more than 50 crores of gold and 10 crores of silver left the country.

Travellers may visit India for mere pleasure and may be either tourists or commercial travellers who make visits for the purpose of popularising their manufactures or arranging for the purchase of Indian commodities and generally entering into relations with traders in India. These people spend money in



India during their stay and, as the money has in the end to come from their own country they create a supply.

Every year large amounts are remitted from India as profits and dividends of investments in India and as savings of Europeans employed here. The total of these remittances is not exactly known but is estimated to be about 12 crores on the average. They create a demand for sterling as they are mostly remitted to London.

The amounts remitted by Indians for investment abroad is very small, but it sometimes assumes big proportions as in 1929 and 1930. To the extent to which these amounts were investments of European concerns or of Indians taking money out of the country this is termed a "flight of capital" and creates a heavy demand for foreign currencies. Of course, when the money returns to India it creates a supply.

Credits on account of travellers abroad are not very large but there is no estimate of the expenses of our Princes abroad though it is understood that they buy large amounts of sterling for their tours. 5491

Government operations form a very important feature in our country. We have already referred to the loans floated by the Government abroad. The interest on these loans creates an annual demand for sterling. Foreigners investing in this country in Government loans also have to remit the interest earnings. Moreover, the Government has to maintain the Secretary of State for India and to pay leave, pension and other gratuities of its European servants living abroad. These are commonly known as "Home Charges" and come to a substantial amount. In addition there are also the savings of European servants of the Government which are sent out.

If, after all the invisible and visible items are adjusted there emerges an excess of exports, it means that the supply of exchange is more than the demand for it and the rate of exchange obeys the economic law that the more the supply, the lower the price and the fewer the rupees which one will get by selling the foreign currency. If the result is an excess of imports it means that the demand is more than the supply

and the price will go up and people will have to pay more rupees to get the foreign currencies.

In accordance with this, the following table gives the foreign trade balance of India, prepared from the summary in official returns without detailed classification. It will be seen that the volume of private remittances which include profits of foreigners, expenses of our Princes abroad and miscellaneous items amount to more than 20 crores per annum on an average :—

*Table 4—Balance of Trade for India.*

	1924-25	1925-26	1926-27	1927-28	1928-29	1929-30	1930-31
<i>Credit items.</i>							
Exports of merchandise ...	398	385	309	329	338	311	220
Transfers by Government ...	38	—	—	28	—	—	7
<i>Debit items.</i>							
Imports of merchandise ...	243	224	230	247	251	239	164
„ bullion (net) ...	94	52	39	32	34	26	24
Government remittances ...	56	61	3	38	41	20	7
Freight items (export) ...	12	11	11	11	11	11	11
Private remittances ...	31	36	26	29	1	15	21

The United States and Britain are countries with a large volume of invisible exports. The former has a surplus of exports while the latter has a surplus of imports. Japan is a country which has invisible items on both sides of the account. The following statements show the elements in the balance of payments of these countries.

*Table 5—Balance of Trade for Great Britain.*

(From W. F. Spalding's "Foreign Exchange and Foreign Bills" and the Bulletin of Statistics of the League of Nations).

	(in millions of pounds)		
<i>Items</i>	1925	1926	1927
Imports of merchandise ...	1,167	1,116	1,095
Exports of merchandise ...	773	653	709
Net shipping income ...	124	120	140
Net overseas investments ...	250	270	270
Net commissions etc.* ...	60	60	63
Other services ...	15	15	15
Total exports ...	1,222	1,118	1,197
Net favourable balance ...	55	2	102

\* The item commissions represents chiefly bank acceptance charges and interest earnings.

*Table 6—Balance of Trade for the United States.*

(From W. G. Edwards' "International Trade Finance" and Bulletin of Statistics of the League of Nations)

<i>Items</i>	1920	1923
	in millions of dollars	
<i>Credits</i>		
Current items visible		
Exports of merchandise	8,080	4,091
Exports of bullion ...	26	...
Exports of currency ...	103	50
Current items invisible		
Interest on loans (net) ...	50	417
Ocean freight (net) ...	93	...
Capital items		
Foreign loans paid off ...	571	23
Securities sold ...	...	371
Debts repaid to us ...	...	91
Total ...	8,923	5,043
<i>Debits</i>		
Current items visible		
Imports of merchandise ...	5,100	2,732
Imports of bullion ...	50	200
Imports of currency ...	...	...
Current items invisible		
Government expenses abroad ...	305	19
Ocean freight (net) ...	...	8
Immigrants' remittances ...	700	360
Tourists' expenses abroad ...	150	400
Capital items		
New foreign loans ...	506	377
Other investments abroad ...	939	33
Total ...	7,750	5,225
Net balance of trade ...	+ 1,173	- 182

*Table 7—Balance of Trade for Japan.*

("Ashahi", Present Day Japan, 1929, English edition).

<i>Items.</i>	1926	1927
	in millions of yens.	
<i>Visible credits and debits</i>		
Exports of merchandise ...	2,119	2,065
Imports of merchandise ...	2,563	2,359
Balance of trade visible ...	-444	-294

<i>Invisible credits</i>				
Interest due from abroad	...	...	13	13
Investments and services	...	...	122	121
Shipping income	...	...	193	200
Insurance income	...	...	92	96
Tourists' expenses	...	...	48	51
Government income overseas	...	...	21	27
Other items	...	...	17	16
<i>Capital account credits</i>				
Investments in Japan	...	...	177	153
Overseas loans repaid	...	...	87	46
Total			773	723
<i>Invisible debits</i>				
Interest payable	...	...	104	104
Shipping services	...	...	67	67
Insurance	...	...	90	96
Tourists' expenses abroad	...	...	25	28
Government expenses abroad	...	...	67	69
Other items	...	...	16	11
<i>Capital account debits</i>				
Investments repaid	...	...	154	181
Overseas loans	...	...	74	106
Total			597	662
Net invisible items	...	...	176	61
Net Balance of Payments	...	...	-268	-233

## CHAPTER V.

## THE TERMINOLOGY OF THE EXCHANGES

*"A rose will smell as sweet by any other name"*

Favourable and unfavourable—Firm, weak, etc.—Premium, discount—Direct or fixed, indirect or moveable rates—"For us" and "against us"—Exchange maxims.

When the exports of a country are in excess of the imports the balance of trade is usually called "favourable" and when imports are in excess the balance is said to be "unfavourable" or "adverse". These terms are in reality reminiscent of the mercantilist school of thought as it was believed that a favourable balance of trade meant imports of gold and an adverse

one meant exports of gold. At least that would be the final adjustment of the balance of trade.

This must be taken with a good deal of reservation. In the first place, we have seen that countries like England have an adverse balance of trade as regards merchandise but a favourable one when all invisible items are taken into account. Secondly, what we mean by the terms is with reference to the whole country ; but as foreign trade involves both exporters and importers, it will be found that the interests of the one are opposed to those of the other set. When exports are in excess, it means that the supply of exchange is greater than the demand and exporters will get less local currency for their goods than before. This is particularly true of India where exports have their prices fixed by international competition in sterling prices and import prices are settled likewise by the foreign manufacturers. Hence as the exporters cannot demand a higher sterling price, they have to be satisfied with fewer rupees for their goods. Thus, for £1,000 worth of goods, instead of receiving Rs. 13,333 at 1/6, they would get only Rs. 13,310 at 1/6  $\frac{1}{2}$ . They will thus lose Rs. 23 or 17% on their price. The importer on the other hand is a gainer by this rise in the value of the rupee as, for the same £1,000 he need pay only Rs. 13,310 or Rs. 23 less. It is therefore favourable to the importer and unfavourable to the exporter, which is something that is almost completely opposite to the idea of the mercantilist who thought that an excess of exports was good for the exporters who brought about the "favourable" balance of trade.

Similarly if there is an excess of imports, it means that importers have to pay more for their goods and exporters get more rupees for their foreign currency. The balance of trade is therefore "unfavourable" to the importers and favourable to the exporters. They would be encouraged to export more on account of the higher rupee prices they can get for their goods. Consequently the terms "favourable" and "unfavourable" must be understood as referring to the interests of the nation and the importers, but always in the opposite sense to the case of the exporters who are the persons through whose efforts the increase in the gold holding of the country was to be increased.

Thirdly, these terms are used for the movements in the rate, as when people say that the rate has moved in "our favour" when it is their intention to applaud the efforts of the exporters in achieving this success. But the favourable rate means that the external value of the local currency has appreciated and that exporters will get discouraged for the future. Similarly the rate moves "against us" and importers are discouraged for the future because of the high local prices they have to pay for the foreign currency. This means that, so far as the country itself is concerned, a favourable balance of trade means that importers receive encouragement, which is unfavourable to the country ; and an adverse balance of trade means that exporters receive encouragement, which is good for the country.

Fourthly, assuming that the terms apply only to the importers, the favour or disfavour is only so long as there is a movement in the value of the currency. But when a new level is reached, the rate becomes static and there is no more favour or disfavour to the importers or the exporters, as the exports and the imports balance each other at that rate of exchange. Thus, in the case of India, a certain volume of exports and a certain volume of imports balanced each other when the rate was sixteen pence per rupee. But after the rate was raised to eighteen pence, a new level of exports and imports has been created at that price of the rupee and the theoretically favourable nature of the eighteen pence ratio for the importer has almost completely disappeared. True, exporters have to send out more goods to obtain the same rupee amounts, but at the same time the rupee is able to buy more goods and services than before and their expenses in producing the goods is thus less than before. The importers may think that they have to pay less for the goods they import, in rupees, but as the prices at which they sell are in rupees which have appreciated to eighteen pence, they can sell them only for a fewer number of rupees. In the end it would appear that the country is very nearly where it was before.

Even in a manufacturing country a favourable balance of trade is not always healthy. But in an agricultural country where a year's produce *has* to be sold in order to carry on

the next year's operations, the effects are more harmful. There are certain items such as wages for production, cost of transportation, agency and other services, freight etc., which are fixed and do not easily follow the rate of exchange. The producer will therefore be discouraged by the favourable rate. The curtailment of production would be a corrective of prices and thus affect the exchange rate by decreasing the supply. But if the movement is of a permanent nature, the agriculturist is cut off from the markets of the world as his overhead charges remain the same but the local prices realised by his goods do not give him a margin of profit. It would then be found that the pendulum had swung too far.

Similarly, when imports are in excess, and the balance of trade is adverse, it is the exporters who find that it is profitable to export goods and this acts as a corrective on the exchange rate in usual times. But the capacity for such an increase in exports is limited. Manufactured goods may find new markets or new manufactures might be created for selling in existing markets. But agricultural produce cannot generally find new markets, for people are already using them and they cannot use more of them, particularly if they are food products. This was brought out at the recent International Wheat Conference when it was attempted to find out whether new markets could be found for the surplus wheat of the United States, Canada, Argentina and Australia and it was recognised that unless countries like India gave up rice and took to wheat there was nothing to be done. This was, of course, unthinkable, for the rice-growers must do something for their employment if they gave that up and they cannot find any means of paying for the wheat which they will import.

The futility of trying to follow the exchange rate in abnormal times was shown during the war and postwar developments in India. In the war period the heavy demand for Indian produce made it impossible to control its movement from 16d up to 34d. and when the war ceased and India found it possible to buy goods in return, the downward movement could not be checked and the rate slipped down to less than fifteen pence. During these stages, it could not be said that a new static level

was reached as the rate was constantly on the move. The Government tried its best to follow the rate and steadily raised the official value of the rupee when it was rising and when it seemed for a year to be steady at around 24 pence (gold), the Babington-Smith Committee's recommendation that it should be stabilised at that level was accepted and in trying to maintain it there and then at 24d. sterling the Government had to sell £55,382,000 of their sterling resources which brought a loss of about 40 crores to the country.\*

When we refer to a movement in the exchange rate, we are often referring to the appreciation or depreciation of the rupee in terms of foreign currencies. When we say that the rate has moved up, we mean that the rupee has risen in external value and, as a consequence, foreign currencies have depreciated in terms of the rupee. As the rupee is worth more pence, the pound is worth less rupees. As the rupee is worth more dollars, the dollar is worth less rupees. In fact it is like the scalepans of a balance and an upward movement of one currency brings about a downward movement of the other and a downward movement causes an upward movement of the other. What is one man's gain is another man's loss.

The rates in any country may be quoted in the local currency when they are referred to as *direct* or *fixed* exchanges or in foreign currency when they are called *indirect* or *moveable* exchanges. Thus in India sterling is quoted at so many pence per rupee and is a moveable exchange like francs, marks and guilders. The dollar is quoted in rupees per hundred and it is a fixed exchange like the yen, Shanghai tael, Hongkong dollar etc. In London most rates are quoted in local currency but some are given in foreign currency. In New York, Montreal, Paris, Berlin and most other centres all rates are quoted in local currencies. This uniformity has several advantages but it is not possible to change the Indian method of quoting as habits are often too strong for reason to control.

It may be pointed out that one advantage of quoting in rupees instead of in pence is that wholesale and retail prices could become operative. At present, the buyer usually has

\* B. E. Dadachanji, *History of Indian Currency and Exchange*, p. 136.



to pay the same rate whether he buys £30 or £3,000 and the seller can expect the same rate even if he offers to sell £50 instead of £5,000. If the quotation were in rupees, the legal parity would be Rs. 13-5-4 and the normal quotations would become Rs. 13-4-11½ and Rs. 13-5-8½ for buying and selling, with the same margin as at present. For large amounts, the rates might be Rs. 13-5-0 and Rs. 13-5-8 while for very large amounts they might be Rs. 13-5-1 and Rs. 13-5-7. The equivalent of 1/5¼ would be Rs. 13-8-4 and that of 1/6¼ would be Rs. 13-1-0.

People often refer to the rates as being *firm*, *strong* or *steady* and on the other hand as being *weak*, *easy* or *quiet*. They do not mean the same thing for all the rates. When the rates are quoted in local currency, a rise in the rate of exchange means that the foreign currency is worth more than before and the rupee has depreciated. When the rate has gone down it means that the foreign currency has lost in value or the rupee has appreciated. In the case of the moveable rates the rise in the rate corresponds to a rise in the value of the rupee and a fall in the rate means a fall in the value of the rupee. This difference in the meaning of the words must be remembered in order to avoid the habit of extending the use of the terms to both the rate and the rupee as in the case of sterling to other currencies. .

Sometimes the words "premium" and "discount" are used of the exchange rates. These terms can properly be used only of the rate between countries with the same currency units. Thus we may say that between Ceylon and India, Indian rupees are at a premium of ½% in Colombo, meaning that one can get only Rs. 99-8-0 for Ceylon rupees 100 or, which is nearly the same thing, one can get Rs. 100 for Ceylon Rs. 100.50. The reverse will be the case in India, the Ceylon rupees are at a discount, meaning that Ceylon Rs. 100 can be got for Rs. 99-8-0 or Ceylon Rs. 100.50 can be got for Rs. 100. Similarly the words may be used to denote the relation between Australian or South African pound and the London pound. It could also be used for speaking of the rate between the United States and the Canadian dollars and even with regard to the U. S. dollar

and the Manila peso because the latter is exactly half a dollar by law. It is misused in the case of the ordinary exchanges. For example if we say that dollars are at a premium, what we mean to imply is that the value of the dollar is more than Rs. 2.74 which is the legal parity value. But confusion is bound to arise when people use the terms for the rates themselves for a premium in the *rate* may often mean a discount in the *currency*, and a discount in the rate may mean a premium in the currency.

In ordinary circumstances, it does not matter whether we say that one unit is at a premium over the other or that the other is at a discount under the first. Thus whether we say that the Australian pound is at a discount of  $\frac{1}{2}\%$  or that the sterling pound is at a premium of  $\frac{1}{2}\%$ , it is the same thing. For, in the latter case, we mean that Aus. £100 $\frac{1}{2}$  will have to be given for £100 sterling, that is, Aus. £100 = £  $\frac{100 \times 100}{100\frac{1}{2}}$  = £99-10-0.6 which is the same as saying that Aus. £100 equals sterling £99 $\frac{1}{2}$ , though on very large amounts such as £10,000 it might make a difference of 5s. But if the premium is greater, it makes quite a difference. For example, at 10%, the latter means that Aus. £110 = £100 or Aus. £100 = £  $\frac{100 \times 100}{110}$  = £90-18-2 which is not the same thing as saying that Aus. £100 equals sterling £90. If the difference goes as far as 35%, as it has done recently, the two values would be Aus. £100 equals £74-1-6 as premium and £65 as discount. Therefore the true equivalent quotation to 35% premium is about 26% discount; to 35% discount is a premium of  $\frac{100 \times 100}{65} - 100 = 54$ .

The rates are often referred to as "high" or "low" and as being "for us" and "against us." It is obvious that these have opposite meanings for the fixed and moveable exchanges. A high rate for sterling means that the rupee has appreciated and this is believed to be "for us" in the sense that an excess of exports is indicated by the high rate. A low rate for sterling means that the rupee has gone down and this is believed to be "against us" in the sense that an excess of imports is indicated. But in the case of the dollar rate, a high rate is really "against us" in this sense and a low rate is "for us."

The rule to be followed in buying or selling foreign currencies is that you must pay less when you buy, and get more when you sell. The case is simple when the rates are quoted in home currency as one can easily realise that in order to make a profit he must buy at the lower rate and sell at the higher rate. Thus one must buy dollars at 273 and sell them at 274 making a profit of one rupee per hundred dollars dealt in. If yens are dealt in, one must buy at 134 and sell at 135 to make a profit. The rule is expressed by the maxim "Buy low and sell high". In buying bills, the rule is "The better the bill, the higher the rate" which means that more rupees will be paid at the higher rate, for bills which are more reliable or which will give the foreign currency earlier. The rule is exactly the reverse when you deal with moveable exchanges. It is then "Buy *high* and sell *low*" and "The better the bill, the *lower* the rate". Thus you have to pay fewer rupees when you buy sterling or you must get more pence for every rupee you pay and the *higher* rate must be used. When selling you must get more rupees or you must give away fewer pence for each rupee and you must sell at a *lower* rate than you bought at.

The difference is also dynamic in the sense that the same factors which tend to move the fixed exchange rates in one direction will tend to move the moveable rates in the other direction. Thus, if imports are in excess, the rupee should depreciate and the fixed rates should go "high" and the moveable rates should go "low." The dollar and other rates should go high and the sterling and other rates should go low. Similarly when exports are in excess, the rupee would tend to appreciate and the fixed rates should go "low" and the moveable rates should go "high." These variations are sometimes referred to as a "rise" or "fall" in the exchanges, but these must be taken to mean a rise or fall in the value of the local currency and not in the exchange rates.

This change in the meaning of the words "high" and "low" is also illustrated in the rates quoted for ready or cable transfer payments and for deferred or demand draft deliveries. The former are worth more rupees and the latter

less rupees because payment in the foreign country is later though payment in India is at the same time in both cases. Therefore for the fixed exchanges the cable rate, or the T. T. rate as it is called, will be higher than the draft or D. D. rate or sight rate. In the case of the moveable rates, the T. T. rate will be lower than the D. D. rate. To bring the meaning clearly to the mind, we might adapt a little chorus and say :—

Just sing this little chorus  
And sing it every day  
"That higher rates are for us  
And lower the other way."  
That is when quoting units  
To every rupee found  
But rupees to foreign units  
It's the other way round.  
For then you'll sing your chorus  
Every day until you die  
"That low rates will be for us  
While those against us will be high."

Or to adapt a saying of Hartley Withers :—

Baba was a crafty man, Baba was a liar,  
When he wanted London cheque, he swore it came higher.  
Baba was a crafty man, Baba *was* a liar  
He sold a London cheque, was pleased the rate was higher.

## CHAPTER VI.

### WHAT IS FOREIGN EXCHANGE.

*"Behold, the golden gates are open."*

What is the exchange rate—A comparison with inland exchange rates—Limits and variations in the rate—Why a bank for exchange—How it settles claims in various countries—The system of settling our foreign accounts.

The subject of foreign exchange is a fascinating one to those who have understood it and a bewildering one to those who are to be initiated into it. However much you may try to explain, the novice is in the position of the lady to whom all about the engine pulling the train had been explained and

*then asked the most intelligent question "But where is the horse to pull it?"* The novice hears the whole story and then asks "Yes, I follow you very well, but if a rupee is legally equal to 18 pence, how is it that banks say it is worth  $18\frac{3}{4}$  d. at one time and at another time that it is worth  $17\frac{3}{4}$  d.? How is it that the gold dollar which is worth 25.52 French francs by law is worth 25.40 francs sometimes and 25.60 francs at other times? How is it that the sterling pound which is worth 4.86 dollars, both coins being of gold, is worth 4.84 or 4.88 at the sweet will and pleasure of the exchange banks?" But once a person is able to grasp why these changes in value take place, he has understood the whole subject of foreign exchange and the rest is a matter of detail.

"Foreign exchange" is a term that has been loosely used everywhere. It has been used to refer to the exchange rate as when people say "The exchanges are moving against us." It has been used to mean more correctly the supply and demand of foreign currencies or the currencies themselves as when banks advertise that they "sell and buy foreign exchange." The Encyclopædia Britannica defines it as a "system by which commercial nations discharge their debts to each other", that is, it is a process of accounting. The subject of foreign exchange should therefore comprise an examination of the methods by which accounts between two countries are settled and the methods employed in financing the movement of goods between them. It should also deal with the pure theory of economic laws relating to the working of these operations and of the organisations and devices by which the commercial world adjusts international trade relations.

To understand how the exchange rate works, it will be useful to see what happens inside a country when goods move from one place to another and then extend the method of reasoning to movements from one country to another. If B in Bombay sells goods to C in Calcutta worth Rs. 100/-, he must receive from C something which he can dispose of in Bombay and which will fetch him the Rs. 100/-. The best means of doing so is for C to send him Rs. 100/- because Rs. 100/- is worth the same anywhere in India. He may go to his bank

*and ask for Rs. 100/- payable in Bombay. But though Rs. 100/- is worth the same amount anywhere in India, the money in Calcutta is not the same as the money in Bombay because the man in Calcutta must send the money to Bombay. The bank which undertakes this work is entitled to compensation for its trouble and expense, and charges the remitter about four annas per Rs. 100/-. Bombay funds in Calcutta will therefore sell at  $100\frac{1}{4}$ . If at the same time there is in Calcutta a person who wants to get money for Rs. 100/- which someone in Bombay owes him, he may go to his bank and, after satisfying it of the genuineness of his claim, might assign his rights to the bank and receive in exchange Rs. 100/- less a compensation. He will thus get Rs.  $99\frac{3}{4}$  for his 100 rupees in Bombay.*

It is possible to argue that as the bank sold the Bombay funds at  $100\frac{1}{4}$ , it should buy them from the second man at  $100\frac{1}{4}$  or at least 100. But the bank would reply that, so far as it is concerned, Bombay funds are a commodity in which it deals and there must be some margin between the rate at which it will buy the commodity and the rate at which it will sell it. This is the same difference as is observed to be charged by a merchant, who buys rice, wheat, cotton or any other product for the purpose of selling it to others.

Thus while Rs. 100/- in Bombay is theoretically the same as Rs. 100/- in Calcutta, in practice, it is not the same. Though the parity value between Bombay rupees and Calcutta rupees is 100 the exchange value is between  $99\frac{3}{4}$  and  $100\frac{1}{4}$ . It often happens that there is a heavy demand for Bombay funds and the banker has to charge more for selling them as he is not sure that he can buy as freely as he can sell. In other words, the supply of the commodity has been exceeded by the demand and prices must go up. The bank may charge Rs.  $100\frac{3}{8}$  or even  $100\frac{7}{8}$  and, in order to increase the supply, may offer as much as  $99\frac{7}{8}$  or even 100 for sellers of Bombay funds. Similarly if there should be a large supply and people are anxious to dispose of their Bombay funds, the banks would consider that demand may not be enough and offer fewer rupees in Calcutta for the Rs. 100/- in Bombay and the rate may be quoted so low as  $99\frac{5}{8}$  or even  $99\frac{1}{8}$  and offer to sell Bombay funds at

$100\frac{1}{4}\%$  or even 100. The margin of profit to the bank will be nearly the same as before but the amount charged to the buyer will vary with the changes in the volume of supply and demand.

It will thus be seen that the relation between Bombay funds and Calcutta funds is exactly the same as exists in other commodities and subject to the same economic laws. There are wholesale prices as when banks will sell Rs. 100 at  $100\frac{1}{4}\%$  but will sell Rs. 10,000 at  $100\frac{1}{8}\%$  and Rs. 1,00,000 at  $100\frac{1}{16}\%$  and in the same way buy Rs. 100 at  $99\frac{3}{4}\%$ , Rs. 10,000 at  $99\frac{7}{8}\%$  and Rs. 1,00,000 at  $99\frac{15}{16}\%$ . But there is a limit to these variations in the wholesale and retail rates determined by the cost at which other means of remittance are available. Thus C might go to the Post Office and send a Money Order at a cost of one rupee per Rs. 100/-. Or he may send it by insured post at a cost of five annas for small amounts and three annas for higher amounts and two annas for large amounts. Similarly the man who wanted to sell Bombay funds could ask his debtor to send him rupees by any of these three methods.

It may be asked why it is that the clients do not deal with each other direct. In the first place it is not easy to hunt out the men who want to buy what you want to sell or who want to sell what you want to buy. The reason is just the same as what makes it possible for shops to be opened for selling goods. Even if you find a seller, he may not sell you just what you want, or may not have enough of it. You may not know how to get in touch with another man who will sell you the rest of your needs. But the shopman will sell you exactly what you want to buy and has it ready. Similarly he buys from people just what they have to sell and will buy them at once. The bank selling or buying Bombay funds in Calcutta is in that sense a trader to whom people resort in the same way as to the shopman.

Similar is the working of the foreign exchange bank. Instead of dealing with Bombay and Calcutta funds which have a relation of equality with each other, the exchange banker deals in currencies like pounds, dollars, francs which have a fixed legal relation to each other as defined by the laws of the respective countries. The price at which these currencies

are bought and sold are not the same as these legal values or parities as they are called, but the cost to the banker of buying them himself when he is asked to sell to others and of selling them if he is asked to buy. The prices will therefore vary with the supply and demand of foreign currencies but these variations cannot go beyond what it would cost others to send abroad or to import from abroad the currency which would be paid in settlement.

One advantage of going to a bank to buy the exchange is that the buyer has a double guarantee that the funds will be paid to him or his nominee in the foreign centre as a matter of certainty while private parties may fail in the meantime ; and that it is often possible to arrange with the bank to make the payment in the foreign country against proper identification of the nominee. In the same way the seller has the advantage that if there are any goods connected with his foreign currency claim, the bank or its agent abroad would protect his interests and would also carry out his instructions regarding dealings with the foreign importer.

Supposing that A in India sends out goods to B in England to the value of Rs. 4,000, B has to pay A this sum. If at the same time C in England sends out to D in India goods worth Rs. 4,000 D has to pay C this sum. Now instead of B sending out money to India and D sending out the same money to England, it would be a good arrangement if D could pay the Rs. 4,000 to A in India and ask his creditor C in England to receive the amount of £300 which is the sterling equivalent, from B. The method of making these settlements is illustrated in the following diagram :—



Diagram 5. Direct settlement of foreign accounts.

It might be that while A exports goods for Rs. 4,000 to B in England, C there does not send goods to any one in India but



sends goods to D in the United States for £300 or \$1,460.00 and E there might send goods for \$1,460.00 or Rs. 4,000 to F in India. Then the bank in India pays A Rs. 4,000 and gets it back from F by the following process. Its agent bank in England receives £300 from B and uses it to pay C. The agent bank in the United States receives £300 or \$1,460.00 from D and pays it to E, who has to receive money from F for the goods he has sent him, and F pays it to the bank in India. Thus, without actually sending any money, the three exchange banks have, by a process of accounting, adjusted the payments in all the three countries. They make a charge for their services and hence arise buying and selling rates for sterling and dollars in India, for rupees and dollars in England and for sterling and rupees in the United States. This is represented in the following diagram :

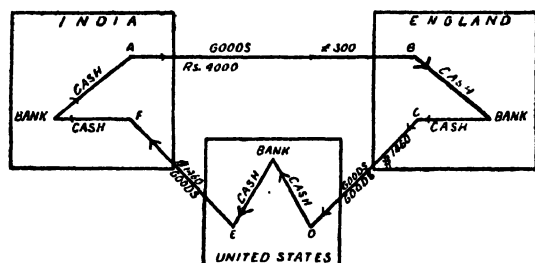


Diagram 6. Indirect settlement of foreign accounts.

Supposing that some people export to England 100 crores or £75 millions worth of goods and some others import from England 100 crores worth of goods, the exporters would approach the exchange bank and ask it to buy from them their claims for London funds and the importers will ask the exchange bank to pay out the London funds on their behalf. The bank in India will receive rupees 100 crores from the importers and pay out rupees 100 crores to the exporters. Its agent or branch in London will receive £75 millions from our debtors and use the amount to pay our creditors. Of course, as we have seen, there would be a certain charge for the bank's trouble and expense in conducting these operations and thus

we have a selling rate and a buying rate for exchange. There will also be a wholesale and a retail buying rate and a whole-sale and retail selling rate as in the case of the Bombay funds in Calcutta.

It may happen that we do not export all the 100 crores to England nor import all our goods from England. We may import 80 crores from England and export only 60 crores to that country but export 40 crores to Germany and import only 20 crores from it. Then, after the amounts due to us have been settled in Germany, there will still remain 20 crores which they have to pay us. Similarly we have to pay 20 crores more to England after our debtors there have paid our creditors there. We could in this case ask our debtors in Germany to pay the amount over to our British creditors. In practice, we accomplish these payments by taking to the exchange bank here our bills evidencing rights in Germany and it uses the funds to pay our creditors there and takes the balance of 20 crores or £15 millions to London. It also collects the £45 millions due to us in London and with this total of £60 millions it pays our creditors there.

The following figures relating to imports and exports of India for the year 1929-30 will show the distribution of our payments between the various countries. In the case of Britain the invisible imports and the imports of silver and gold are included : —

*Table S—Balance of payments between India and other countries.*

			Exports.	Imports.	Net exports.
			(In crores of rupees)		
Great Britain	...	...	66	174	- 108
Java	...	...	—	14	- 14
Italy	...	...	—	7	- 7
Other British Countries			44	21	+ 23
Germany	...	...	27	16	+ 11
Japan	...	...	32	23	+ 9
United States	...	...	36	17	+ 19
Belgium	...	...	12	7	+ 5
France	...	...	17	4	+ 13
China	...	...	13	—	+ 13
Others	...	...	63	27	+ 36
			310	310	0

We owe a balance of 108 crores to England and 14 crores to Java and 7 crores to Italy or a total of 129 crores against which other countries owe us the same amounts. We thus ask them to pay the amount due to the creditors in England, Java and Italy. The exchange banks in India collect all the amounts due to us from the various countries, pay the amounts due by us to our creditors in those countries and then take the balance to pay our creditors in other countries.

## CHAPTER VII

### THE EXCHANGE MARKET

*"The money-changers did ply their trade in the open mart."*

The exchange market—Variations in rates—Margin between buying and selling rates—Quotations in Calcutta—In Bombay In Madras, Karachi and Rangoon—How the market works—Quotations in other countries.

There are two important exchange centres in India, Calcutta and Bombay. The total trade of Calcutta is about 140 crores of exports and 90 crores of imports and of Bombay is 85 crores of exports and 105 crores of imports. The rates of exchange quoted in these centres are sufficiently competitive. At these places there are the five British "Eastern Banks", Lloyds Bank, Hongkong and Shanghai Banking Corporation, National City Bank of New York, Netherlands Trading Society, Netherlands India Commercial Bank and Yokohama Specie Bank. In Bombay there is also the Comptoir National d'Escompte de Paris and the Sumitomo Bank. The competition between these banks has resulted in fairly close rates being quoted and a spread of  $\frac{1}{16}$ d. between buying and selling sterling is quite usual. At times in 1930 and 1931 the margin has been as low as  $\frac{1}{32}$ d. when the rate hovered near  $1/5\frac{3}{4}$ d. At times when the rate was fluctuating rapidly as in 1920-21 the margin was as much as quarter of a penny. Generally if the selling rate was  $1/5\frac{1}{4}$  for T. T. the D. D. rate would be  $1/5\frac{2}{3}$ , the buying rate would be  $1/5\frac{7}{8}$  for T. T. and  $1/5\frac{9}{16}$  for D. D.

In Madras, Karachi and Rangoon the margin is wider and though the total foreign trade in these ports is about 60 to 80 crores the margin is nearly  $\frac{1}{8}$  of a penny though sometimes it is only  $\frac{3}{8}$ d. Thus with sellers at  $1/5\frac{3}{4}$  buyers would be  $1/5\frac{3}{8}$  to  $1/6$ d.

In India the other currencies are not quoted with the same degree of fineness as sterling, in which more than 85% of the business is done. There is little direct business even in dollars and yens and they are sold through sterling. Banks dealing in them await the morning cable from their London offices showing the closing rates of London on New York, London on Yokohama etc. The quotations for these currencies are all embodied in a course of exchange or schedule which is sent out every morning and every afternoon by the exchange brokers who obtain them from the banks.

It is customary to indicate the "tone" of the market. This is expressed by referring to the rates as weak, easy, quiet, steady, strong, firm, dull, active. These terms are explained below :—

weak :—demand strong, rate likely to go down

easy :—more demand than supply, rate might go lower

quiet :—little business but rate might go lower

steady :—normal business, tendency healthy

strong :—bills in evidence, rate rising and may do so

firm :—very good supply of bills and rate going up

dull :—No business and rate lacks definiteness

active :—good business passing, bills showing and brisk demand

In the case of sterling to which the tone generally refers, a rise in the rate would mean a rise in the value of the rupee and the tendency would therefore apply also to the rupee.

The exchange market like all other markets, consists of buyers and sellers. The buyers will be the public who want to make remittances by T. T. or D. D. or who want to make contracts to buy at a later date, and also the banks who would desire to buy against their sales to the public. The sellers would consist of the public who had claims to foreign currency in the form of ready funds to be drawn upon by cable or demand drafts, or export bills or cable transfers for delivery at a future date, and also the banks who would wish to sell against their purchases from the public. These sellers and buyers usually

*meet through the agency of brokers though sometimes the clients approach the banks directly. If the amounts are small* the clients take the rate quoted by the bank though some may "scout" around for a better rate giving a profit of a few annas. For large amounts they would employ a broker as he would be likely to know the best sellers or buyers as the case may be. The sellers would demand as high a price as possible and the buyers would try to pay as little as possible. But there is always a market price at which business is done and the sellers who are not satisfied will have to wait for some time for better rates though it is just as likely that they may get an even worse rate. Similarly the dissatisfied buyers might wait for a day or two in hopes of more favourable rates but might find the rate more against them. It might also happen that an eager seller might not meet the buyer and the price of sterling go down on account of the surplus exchange and the seller might be forced to accept a worse rate lest the rate should become worse still. In the same way the eager buyer might have to pay a worse rate because he did not meet the seller at the right time.

The price of foreign currency at any time is thus dependent on the competition between the various sellers and the various buyers and there is at any time a tendency due to the temporary excess of sellers or buyers. A fairly equal proportion of both would indicate that the rate was steady at that level and that there was no definite movement likely. If sellers predominate, the chances are that prices will go down and if buyers are very much in evidence, the chances are that prices will go up. These movements in the exchange market were thus explained by Mr. R. G. Hawtrey in a lecture before the London Institute of Bankers (Journal, February 1927) :—

"In any market dealers regulate prices by the state of their stocks. A decline in their stocks means that demand is overtaking supply and points to a rise in price; a growth of stocks means that supply is overtaking demand and points to a fall in price. This is true of the foreign exchange market; the dealers regulate their price for any currency by the state of their stock in it.

"In a commodity market a rise in price checks demand and stimulates supply, while a fall in prices checks supply and stimulates demand. ....An excess or deficiency in the supply of any

currency in the foreign exchange market may be purely casual and temporary and, if dealers believe it to be so, they will make little or no change in their quotations. But if a persistent tendency in either direction makes itself felt or is anticipated, the dealers will make the appropriate change in quotations, and it is in their power thereby to correct the tendency."

The Bombay rates are quoted as follows :—

London,	B.C. T.T.	...	1/5 $\frac{27}{32}$
	B.C. D.D.	...	1/5 $\frac{7}{8}$
	banks selling T.T.	...	1/5 $\frac{7}{8}$
	„ D.D.	...	1/5 $\frac{29}{32}$
	banks buying T.T. ready	...	1/5 $\frac{11}{16}$
	„ D.D.	...	1/5 $\frac{31}{32}$
	„ T.T.	...	1/5 $\frac{31}{32}$ next month.
	„ 90 d/s bills	...	1/6 $\frac{3}{32}$ ready
	„ „	...	1/6 $\frac{1}{8}$ 1 month forward.
	„ „	...	1/6 $\frac{5}{32}$ 3 months forward.
New York,	banks selling T.T.	...	278
	banks buying T.T.	...	277 $\frac{1}{2}$
	B.C. T.T.	...	278 $\frac{1}{2}$
Paris,	banks selling D.D.	...	914
	banks buying D.D.	...	927
	banks buying 3 months	...	936
Japan,	banks selling T.T.	...	137 $\frac{1}{2}$
	banks buying 60 days	...	135 $\frac{1}{2}$
Hongkong,	banks selling D.D.	...	69 $\frac{1}{2}$
Shanghai,	banks selling D.D.	...	86 $\frac{1}{4}$
Singapore,	banks selling D.D.	...	156 $\frac{1}{4}$
Java,	banks selling D.D.	...	89 $\frac{1}{4}$

London, Paris, Java, are quoted in foreign currency. All others are quoted in rupees per hundred foreign units. The forward rates even for sterling are not usually quoted except when there is very brisk business. The quotation for next month's delivery of bills and T. T. is often given.

The Calcutta schedule is as follows :—

London,	B.C. T.T.	...	1/5 $\frac{23}{32}$
	B.C. D.D.	...	1/5 $\frac{3}{4}$
	T.T. selling	...	1/5 $\frac{3}{4}$
	D.D. selling	...	1/5 $\frac{29}{32}$
	T.T. buying ready	...	1/5 $\frac{11}{16}$
	D.D. buying	...	1/5 $\frac{27}{32}$
	T.T. selling next month	...	1/5 $\frac{23}{32}$
	Bills buying 3 months	...	1/5 $\frac{23}{32}$

Paris,	selling D.D.	...	910	
Berlin,	banks selling D.D.	...	149	(Marks per Rs. 100).
Java,	banks selling D.D.	...	89 $\frac{1}{2}$	
	banks buying 60 days	...	91 $\frac{1}{2}$	
New York,	banks selling T.T.	...	276	
	buying 90 days	...	270	
Singapore,	banks selling D.D.	...	157	
	banks buying 60 days	...	154	
Kobe,	banks selling D.D.	...	137 $\frac{1}{2}$	
	banks buying 60 days	...	134 $\frac{1}{2}$	
Hongkong,	banks selling D.D.	...	77	
Shanghai,	banks selling D.D.	...	97	

The following are the Madras rates :—

London,	B.C. T.T.	...	1/5 $\frac{3}{4}$
	B.C. D.D.	...	1/5 $\frac{1}{4}$
	banks selling T.T.	...	1/5 $\frac{1}{4}$
	banks selling D.D.	...	1/5 $\frac{3}{4}$
	banks buying D.D.	...	1/5 $\frac{1}{4}$
	banks buying 3 months	...	1/6 $\frac{1}{32}$
	banks buying 6 months	...	1/6 $\frac{1}{16}$

Market weaker.

France,	banks selling D.D.	...	910	
Germany,	banks selling D.D.	...	148	
American dollars,	selling D.D.	...	278	
Straits dollars,	selling D.D.	...	157	
„	buying D.D.	...	153	
Hongkong,	banks selling D.D.	...	80	
Shanghai,	banks selling D.D.	...	100	
Japan,	banks selling D.D.	...	138	
	banks buying D.P. bills	...	134	(nominal)
Java,	banks selling D.D.	...	88	
	banks buying D.D.	...	92	

The Karachi rates are :—

London,	B.C. T.T.	...	1/5 $\frac{1}{4}$
	B.C. D.D.	...	1/5 $\frac{3}{4}$
	banks selling T.T.	...	1/5 $\frac{3}{4}$
	banks buying 90 days	...	1/5 $\frac{3}{4}$
	bills	...	1/6 $\frac{1}{4}$

The Rangoon rates are as below :—

London,	selling T.T.	...	1/5 $\frac{3}{4}$
	selling D.D.	...	1/5 $\frac{1}{4}$
	buying D/A 3 months	...	1/6 $\frac{3}{32}$
	buying Credits, 6 months	...	1/6 $\frac{1}{16}$

America,	selling T.T. ...	279
Hongkong,	„ T.T. ...	69 nominal.
Shanghai,	„ T.T. ...	87 nominal.
Straits	„ T.T. ...	156½
	buying 30 days	155
Java,	selling T.T. ...	112
	buying 30 days	110¾
Japan,	selling T.T. ...	137¾
	buying 60 days	135¼

It will be noticed that the Java quotation in Rangoon is fixed while in other centres it is a moveable exchange.

The following diagram shows the comparative importance of the ports in our foreign trade:—

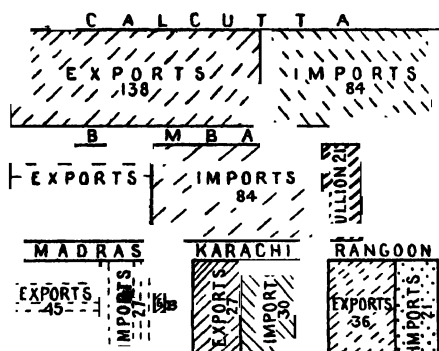


Diagram 7. The foreign traffic of the Indian ports.

Calcutta has more exports than imports and bills are usually in excess in that market, consequently the Calcutta banks often sell in Bombay where imports usually exceed exports. During some months of the year Calcutta sets the rate and the closing rate of Calcutta is usually the opening rate of Bombay the next day. During this period Bombay banks or branches keep themselves in touch with Calcutta rates twice or thrice in a day. This selling in Bombay means that Bombay would have to remit to Calcutta. As most banks have branches in both cities this means that the Calcutta branches carry heavy balances with the Bombay branches or that they have to pay  $3\frac{1}{2}\%$  to the Imperial Bank of India for transferring the funds. When the Reserve Bank is started one of the facilities it will give will be the free transfer of funds and there will not be that difference



between short term money rates in Calcutta and Bombay which is now usual.

During certain months, between July and September when Calcutta has stopped selling, the demand for remittances in Bombay rules the market and it is then Calcutta's turn to watch Bombay rates but even then it is Calcutta that would sell and the demand for Calcutta funds in Bombay therefore persists almost all through the year.

The course of exchange in London comprises practically every country in the world as it has dealings with almost all of them. Our dealings being confined only to a few the exchange schedule is also limited. The course in New York consists of the important ones. Examples are given below as of a certain day. One of the peculiarities of the London exchange rates is that most of them are quoted not so much in London as in other countries and London follows the movements of the rates in those centres. It is due to the fact that London draws in sterling and is drawn on in sterling so that it is the supply and demand for sterling in any country that determines its exchange rate on London.

"Cours des changes" in Paris is exactly like the London one except that all quotations are in local currency. The Berlin quotation is like a German compound—very comprehensive—and is called the "wechsulkurse" (perhaps one might be excused for reading it 'vex all curse'). It gives Berlin quotations on all centres and it also gives the foreign quotations on Berlin, such as in London, Paris, Zurich, Amsterdam, Copenhagen, Stockholm and Vienna.

### Rates of Exchange in London.

London on	Method. of quoting.	Usance	Par.	March 26, 1931
New York ..	dollars per £	T. T.	4·86½	4·85½ to ½
Montreal ..	dollars per £	T. T.	4·86½	4·86½ to ½
Paris ..	francs per £	T. T.	124·21	124·20 to ·22
Berlin ..	marks per £	T. T.	20·43	20·38½ to ·39½
Amsterdam	florins per £	T. T.	12·107	12·12 to 12·12½

*Rates of Exchange in London,—(Contd.)*

London on	Method. of quoting.	Usance	Par.	March 26, 1931
Brussels .. ..	belga per £	T. T.	35·00	34·91½ to ½
Milan (Italy) ..	lire per £	T. T.	92·46	92·75 to ·77
Berne (Switzerland) ..	francs per £	T. T.	25·22½	25·24½ to ·25½
Oslo (Norway) ..	kroner to £	T. T.	18·159	18·15½ to ·16½
Stockholm (Sweden) ..	kronor to £	T. T.	18·159	18·13½ to ·14½
Copenhagen (Denmark) ..	kroner to £	T. T.	18·159	18·16½ to ½
Madrid .. ..	pesetas to £	T. T.	25·22½	45·10 to ·15
Lisbon .. ..	escudo to £	T. T.	4·50	108½ to ½
Vicnna .. ..	schillings to £	T. T.	34·58½	34·55 to ·58
Prague (Czechoslovakia) ..	krone to £	T. T.	164½	163½ to 164
Belgrade (Yugoslavia) ..	dinars to £	T. T.	25·22½	276½ to ½
Budapest (Hungary) ..	pengo to £	T. T.	27·82	27·86 to ·89
Bukarest (Roumania) ..	lei per £	T. T.	813·6	816 to 818
Sofia (Bulgaria) ..	leva to £	T. T.	673·659	668 to 673
Athens .. ..	drachmae to £	T. T.	375	374½ to 375½
Constantinople ..	piastres to £	T. T.	110	102½ sellers
Moscow (Soviet Russia) ..	roubles to £	T. T.	9·46	9·435 to ·454
Warsaw (Poland) ..	zloty to £	T. T.	43·38	43½ to ½
Helsingfors (Finland) ..	F. marks to £	T. T.	193·23	192½ to 193½
Kovno (Lithuania) ..	lits per £	T. T.	48·66	48½ to 49
Reval (Esthonia) ..	kroon to £	T. T.	18·159	18·20 to ·27
Riga (Latvia) ..	lats to £	T. T.	25·22½	25·20 to ·30
Alexandria (Egypt) ..	piastres to £	sight	97½	97½ to ½
Buenos Aires (Argentina) ..	pence to peso	T. T.	47·62	39½ to ½
Rio de Janeiro (Brazil) ..	pence to mils	90 days	16·70	3½ to ½
Montevideo (Uruguay) ..	pence to peso	T. T.	51	34½ to 35½
Valparaiso (Chile) ..	pesos to £	90 days	40	39·95
Lima (Peru) ..	ling. to Per. £	90 days	par	17% pm.
Calcutta .. ..	} pence to rupee	T. T.	18	1/5½ to ¾
Bombay .. ..				
Madras .. ..				
Hong Kong .. ..	ster. to dollar	T. T.	...	1/0½ to ¾
Shanghai .. ..	ster. per 'ael	T. T.	...	1/3½ to 1/4½
Singapore .. ..	ster. to dollar	T. T.	28. 4d.	2/3½ to 1½
Kobe (Japan) ..	ster. to yen	T. T.	24·57d.	2/0½ to 1½
Manila (Philippines) ..	ster. to peso	T. T.	24·066	2/0½
Mexico .. ..	pesos to £	T. T.	9·76	10·15 to ·30
Siam .. ..	ster. to Baht	T. T.	21·82d.	1/9½
Ecuador .. ..	sucres to £	sight	24·3325	24·60
Venezuela .. ..	bolivares to £	T. T.	25·25	29·39
Colombia (Bogota) ..	pesos to £	sight	5	5·03
Nicaragua .. ..	cordobas to £	sight	4·8665	4·92
Salvador (Guatemala) ..	colones to £	sight	9·73	9·92
Bolivia .. ..	bolivianos to £	sight	13·33	13·46½

**South African Exchange rates.**

		From March 16, 1931		From March 14, 1931	
		London on South Africa		South Africa on London	
		Buying	Selling	Buying	Selling
T. T.	..	..	½% dis.	par to ½% pm	½% pm.
Demand	..	1½% dis.	¾% dis.	½% dis.	½% pm.
30 days	..	1½% dis.	¾% dis.	½% dis.	½% pm.
60 days	..	2½% dis.	¾% dis.	1½% dis.	½% pm.
90 days	..	2½% dis.	¾% dis.	1½% dis.	½% pm.
120 days	..	3½% dis.	1½% dis.	2½% dis.	...

**Overseas Dominion Rates.**

		London on		On London	
		Australia	New Zealand.	Australia	New Zealand.
T.T.	Buying	...	...	130	109½
	Selling	...	109½	130½	110
Sight	Buying	131½	111½	129½	108½
	Selling	130½	110	130½	109½
30 days	Buying	132½	111½	128 ½	108
	Selling	...	...	130	109
60 days	Buying	133	112½	128 ½	107½
	Selling	...	...	129½	108½
90 days	Buying	133½	113	128 ¾	107
	Selling	...	...	129½	108½

N.B.—All rates are based on £100 London.

**Rates of Exchange in New York.**

New York on		Par	method of quoting	March 18, 1931
England	...	4·8666	dollars to £ ...	...
60 days	...	...	"	4·83½
Cable	...	...	"	4·85½
Cheques	...	...	"	4·85½
Paris	...	3·918	cents per franc	3·91½
Brussels	...	13·90	" belga	13·93
Switzerland	...	19·30	" franc	19·24½
Italy	...	5·263	" lire	5·23½
Berlin	...	23·31	" mark	23·81
Vienna	...	14·07	" schilling	14·09
Madrid	...	19·30	" peseta	10·36
Amsterdam	...	40·195	" guilder	40·09½
Copenhagen	...	...	...	26·73½
Osk.	...	...	...	26·74
Stockholm	...	...	...	26·77
Athens	...	1·297	" drachma	1·29½

**Rates of Exchange in New York,—Contd.**

New York on	Par	method of quoting	March 18, 1931.
Montreal ... ..	100	„ dollar	... 3/128 dis.
Yokohama ... ..	49·85	„ yen	... 49·35
Hongkong ... ..	...	„ dollar	... 25·70
Shanghai ... ..	...	„ tael	... 33·00
Calcutta ... ..	36·50	„ rupee	... 36·08
Buenos Aires ... ..	103·65	„ peso oro	... 126·45
Rio de Janeiro ... ..	32·42	„ milreis	... 8·05
Valparaiso ... ..	12·125	„ peso	

In prewar days the course of exchange in London used to include the rate for long bills on most countries. But after the war, owing to disturbances in the interest rates of most countries the rates are only quoted for T. T. in most cases, for D. D. in a few cases and for bills in another few. The reason for the interest rate affecting the bill rates will be explained later but whenever bills are offered to a banker he takes the T. T. rate and calculates the bill rate from it. It will be seen that about 30 currencies are quoted in moveable rates while only twelve are quoted in fixed rates. The South African, Australian and Peruvian quotations are given as premium or discount, the rate given being in home currency. All the New York rates are quoted in cents per foreign unit. During the years between 1923 and 1926 some of the exchanges were never quoted as they were depreciating so rapidly that no quotations were reliable. Examples were the Austrian and German rates. The reason for quoting some rates for 90 days bills is that though business in London with most countries is fairly extensive, dealings with these countries are mostly in the form of export bills to them and the proceeds are usually returned to London by draft.

It will be profitable for us to understand how "iters see us" as Burns would say. Taking the case of England first will be seen that the bank selling rupees would like to .16 many pence as possible for each rupee and the rate being ... 3 in pence per rupee must be higher than the buying 1 322 in London the rate is a fixed one and the rule "19 51 low" applies to it. In the same way the D. D. rates are than the T. T. Rate. The London rates would, ous months

T. T. selling  $1/5\frac{3}{4}$  D. D. selling  $1/5\frac{1}{8}$  T. T. buying  $1/5\frac{2}{3}$  D. D. buying  $1/5\frac{3}{8}$ , if the spread between buying and selling is the same as in India. In the same way, a rupee bill will be quoted lower than the D. D. rate.

In Japan rupees are quoted in yens per 100 rupees and the rule would be the same as in London. The T. T. rate on Calcutta being  $73\frac{1}{2}$  a sight bill would be bought for fewer yens and be quoted  $73\frac{1}{8}$  and a 60 days bill at  $72\frac{1}{8}$ . The selling rates would correspondingly be less for sight and usance bills.

In New York the rupee being quoted in cents per rupee, the same rule applies. If D. D. is quoted at 36.35 D. D. would be quoted at 36.20 and 90 days bills 35.90.

In Canada, France and several other countries, all currencies are quoted in home currency and the rule will be the same as in India in the case of dollars and the rates will be quoted in the same way as we do and will move in the same manner. But in the case of francs, marks, florins, or guilders, etc. the rates will move in the reverse direction to us as in the case of sterling in London.

## CHAPTER VIII.

### THE MAJOR EXCHANGES.

*"Eclipse was first——"*

Importance of sterling in India—In other countries—Arbitrated rates—Cross-rates—Dollars—Yens.

The most important medium of exchange in India is sterling. India, like other countries, finds the pound a convenient method of settling foreign accounts. In the first place, for exports her commodities to several countries but, as we have seen the exports to any one country do not balance the imports from it and it is necessary that the debits and credits of various countries should be adjusted on her behalf. That there must be some centre for clearing them. Most of the goods that they find their way practically all over the world buy her goods from most countries. It is

not possible to clear accounts in sterling, francs, dollars, yens, liras, kroners, schillings, etc. without converting them into some common denomination.

Secondly, we have for years past been associated intimately with England and there has been the payment of the "Home Charges," interest payments and remittances of Britishers in India which have all to be made in sterling. Our exports to England fall far short of our visible imports of merchandise and bullion, not to mention the invisible imports; and the balance of about 100 crores has to be paid for by selling our goods to other countries and getting the sterling value. Hence it would appear that we might as well sell the goods in terms of sterling and leave the foreign importers to buy the sterling to pay us.

Thirdly it happens that London occupies a similar position with regard to them also. Almost every one of them has dealings with London such as floating loans, paying interest on them, or receiving interest on their investments in London, repaying or investing in London and generally moving funds to and from London and they are quite willing to settle with us through sterling.

Lastly our trade has been for many years almost predominantly with the British Empire and the habit then acquired has made our traders favour the pound more than other currencies as a medium of settlement. The following figures show the high proportion of our trade with the rest of the Empire, though it is now becoming less:—

*Table 9—Trade of India with the British Empire.*

	British Empire.		Other countries.	
	pre-war	1929-30	pre-war	1929-30
Exports of merchandise	92	115	132	203
Imports of merchandise	102	124	44	116
Imports of treasure	40	25	...	3
Invisible imports	38	50	...	...
Total	272	314	176	322
Percentage of total trade	61	49	39	51

The seasonal variations in the sterling exchange rates are illustrated in the exchange quotations for the various months

of the year. For the purposes of comparison, the annual variations are given one below another, the starting point being suitably adjusted :—

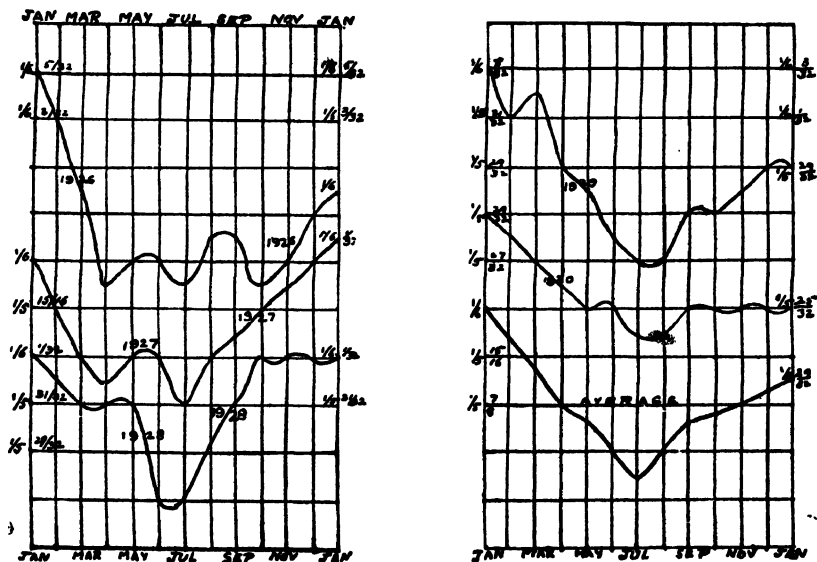


Diagram 8. Monthly variation in exchange rates.

It will be noticed that, on an average, there is a low level in July and a high level in January. Between these months, the general movement is steadily downwards or steadily upwards with slight variations.

Bills on London either after or before acceptance are a favourite form of investment with individuals, commercial and even Central Banks of other countries. Most of the Central Banks are now free from the obligation to keep their gold resources as bullion and as they are prevented from investing too much in local securities they have to seek investments of a liquid nature to earn some interest, which could be disposed of if necessity should arise. The best form of investment is in London in (1) Long term securities of the British Government (2) Securities of the British Government with five years or so to mature and (3) Treasury Bills and commercial bills of short maturities. The first form is not popular on account of

possible capital depreciation. The second form is subject to the same difficulty though to a much less degree. The easiest to dispose of are Treasury Bills and commercial bills. The former which amounted only to £45 millions before the War, assumed the size of £1,037 millions in 1919 and are now about £650 millions. The latter may be acceptances for external or internal trade purposes by the banks, accepting houses and ordinary persons. The bills may also be created in other countries. For example when British importers bring in goods from other countries they have bills drawn on them in sterling which, after acceptance by them or their banks, are valuable security for the investor. Again a foreign importer getting goods from a third country may arrange with his bank to accept the bills as payable in London or have them accepted by a London bank. The banks which purchase these bills abroad could keep them in their portfolio or discount them in the London market and they in turn would be bought by other banks which have money to invest in this form.

These bills are self-liquidating and the banks can easily make their choice according to the period for which they desire to lock up their money. Thus if they have money for 20 days, they have only to apply to some discount house which would give them the right assortment of paper. The bill on London is thus a form of international currency. It is in great demand in all centres and, on account of its ready marketability, it can be used to make payments to any person. One could send a friend a draft or bill on London and he could take it to his bank which would pay him local currency, take the bill to London and receive payment there.

During the war and some years after when the sterling was away from the gold standard and the United States was the only country on the standard, New York made a bold bid for the financial supremacy of the world. It went out of its way to popularise the dollar bills and for a time it seemed as if the hub of the world had been shifted from London to New York and that the "Almighty Dollar" had justified its name. The accumulation of New York money in other markets assumed vast proportions, being estimated at one time at \$12,000 millions



and now at \$20,000 millions. But there was one factor in favour of London which finally restored it to its former position. It was the fact that London was very easily accessible to all parts of Europe. If Denmark wanted to send a London bill to Spain, the time spent in the return of the bill from London to Spain was negligible. But the return from New York in spite of the great speed and regularity of the present-day service is not less than twelve days. Moreover the New York discount market could not compete with the London market in the matter of rates. Force of habit due to being accustomed to deal in sterling made people return to it in a short time. Dollar bills have become popular with the American countries as New York is nearer to them though Europe and other countries deal with them in terms of the sterling pound. Dollar bills also appear in connection with the trade of the United States where the final voice is with that country, as in the case of motor cars, wheat and other exports and jute and some other imports.

The Bank of Japan also made a special effort to popularise yen bills and has succeeded to some extent though some experts think that the working of the scheme has cost the country more than it gained by the sentimental value and the enhanced reputation in other centres. The German Government and the great "D" banks made an effort to popularise the mark bill but with little success chiefly owing to the proximity of Berlin to London. Paris is now putting forth its vast resources in the effort to introduce franc bills and it may succeed to some extent, but whether it does so or not, all these types of bills will never become universal currency like sterling bills.

London is thus the financial centre of the world and almost every country has learnt to think and deal in terms of the pound. The German mark and the French franc will not communicate with each other not only because of generations of hostility but also because they have always talked through the pound sterling. Even such friendly ones like the Italian lira and the French franc believe that though "two is company" there is some value in having a neutral friend at hand.

In India the only exchanges that are worked somewhat independently of sterling are dollars and yens. The former is a monopoly of the National City Bank of New York and the latter is chiefly that of the Yokohama Specie Bank though the Sumitomo and the Taiwan Bank have their own clientele. The last one has had its prestige shaken very much over the 1927 troubles in connection with the Suzuki failure. Other currencies are quoted at their cost in terms of sterling. These rates are known as "arbitrated" rates as opposed to the straight rates which exist between rupees and sterling. The arbitrated rates are based on what are known as the "cross-rates" or rates between London and the required centres. The important cross-rates are daily wired out to India. Those in which we are interested are:—

New York cross rate	...	...	...	485 $\frac{1}{8}$
Paris	"	"	...	124.20
Berlin	"	"	...	20.38
Amsterdam (on account of Java)	...	...	...	12.12 $\frac{1}{2}$
Milan	"	"	...	92.75
Hongkong	"	"	...	1/0 $\frac{1}{2}$
Shanghai	"	"	...	1/3 $\frac{1}{2}$
Kobe	"	"	...	2/0 $\frac{1}{2}$

Together with these quotations come the following:—

London 3 months bill rate	...	...	2 $\frac{1}{2}$ %
" 6 months bill rate	...	...	2 $\frac{1}{8}$ %
" Fine trade bills 3 months	...	...	2 $\frac{1}{2}$ %
" " " 6 months	...	...	3 $\frac{1}{2}$ %
Gold per oz. fine	...	...	sh. 84-11 $\frac{1}{2}$
Silver per oz. standard, spot	...	...	12 $\frac{1}{2}$ d.
" " " forward	...	...	12 $\frac{1}{2}$ d.

Some of these rates are not wired out to the British banks. The yen rates come to the Japanese banks, francs and liras to the French bank, florin and mark rates to the Dutch banks. The dollar rates come to the British banks from London and to the New York banks from that centre. There is often a slight difference in the two rates.

In view of the popularity of sterling as a means of settling our foreign accounts, we usually draw in sterling and others draw on us in sterling. In one sense this has been a disadvantage to London. For if we import goods from Germany

and they draw in sterling, they must sell the sterling and this appreciates the mark in terms of the pound. All the important currencies are thus subject to variations on account of Indian trade. But as our net balance of trade with any one country is not much, it is unable to affect the cross-rates to any extent.

**Dollars** :—The dollar business is chiefly confined to Calcutta where dollar export bills in moderate quantities appear while dollar drafts of American Missions appear in Bombay. Otherwise there is comparatively little supply of dollars as such. The export bills are in connection with jute, raw and manufactured, which America buys here. The imports are mostly motor cars and oils and iron implements. The exporters in Calcutta may use their own funds until shipment of the goods when they sell the bills or they may be agents of American buyers who sell the dollars to buy the goods.

It often happens that when rupees are sold in New York they are available for delivery in Bombay and as the money is required in Calcutta the New York people have to arrange for the transfer of the funds to that city. Besides involving a day this usually costs  $\frac{1}{2}\%$  for the exchange. Calcutta rupees are therefore quoted in New York at a premium over Bombay rupees, though in London both are quoted at the same rate. Thus at 18 pence and a cross-rate of 485, rupees would be quoted at 36·37 cents for Calcutta and 36·36 cents for Bombay.

Dollars are quoted in India in rupees per hundred dollars and consequently the buying rate is lower than the selling rate. The rates usually quoted are for selling and buying T. T. and buying 90 days bills. The demand for T. T. is not persistent though of late the installation of the General Motors, India, Ltd. has created a demand. But as there are practically no dollar bills in Bombay, even they have to purchase dollars on the basis of sterling prices. It is possible that they will also follow the Remington Typewriter Co. and the Singer Sewing Machine Co. and transfer their allegiance to sterling.

Another source of demand for dollars arises from the bills against smaller-sized imports. These importers rarely, if ever, make forward contracts for the dollars and accept the ruling rates when the shipment arrives. The fluctuations in exchange

rates are therefore passed on to the consumers ; unlike sterling where the importers usually protect themselves.

The dollar rates are calculated as follows :—

If the cross-rate is 486 and T. T. on London is  $1/5\frac{2}{3}$  and  $1/5\frac{2}{3}$ , for the selling rate  $485\frac{3}{4}$  is assumed and for the buying rate  $486\frac{1}{4}$  is taken. The selling rate is thus

$$\$100 = \frac{240 \times 100 \times 100 \times 32}{485\frac{3}{4} \times 569} = 277\frac{3}{4}$$

and the buying rate is  $\frac{240 \times 100 \times 100 \times 32}{486\frac{1}{4} \times 571} = 276\frac{1}{8}$

The actual rates would therefore be 278 selling and 276 buying, with closer rates such as  $277\frac{7}{8}$  and  $276\frac{1}{8}$  or even  $277\frac{1}{2}$  and  $276\frac{1}{2}$  for larger amounts.

These arbitrated rates are usually tabulated for ready reference for ordinary movements in the sterling and cross-rate. A specimen table is appended below :—

Table 10—Conversion of dollars into rupees through sterling.

	485½	486	486½	487	487½	488	488½
1/5 $\frac{1}{8}$	277·5	277·2	277·0	276·7	276·4	276·1	275·8
$\frac{3}{8}$	277·1	276·8	276·5	276·2	275·9	275·6	275·3
$\frac{1}{2}$	276·6	276·3	276·0	275·7	275·4	275·1	274·8
$\frac{5}{8}$	276·1	275·8	275·5	275·2	274·9	274·6	274·4
$\frac{3}{4}$	275·6	275·3	275·0	274·8	274·5	274·2	273·9
$\frac{7}{8}$	275·1	274·8	274·6	274·3	274·0	273·7	273·4
1/6	274·6	274·4	274·1	273·8	273·5	273·2	272·9

These tables would be prepared for variations in the cross-rate from 484 to 489 and in the sterling rate from  $1/5\frac{3}{4}$  to  $1/6\frac{3}{4}$ . When the bank has to sell dollars it takes a rate slightly higher than the value shown in the table and when buying dollars it would take a rate somewhat lower than the rate in the table.

**Yens** :—The trade between India and Japan is financed almost wholly by the three Japanese banks. Movements of goods between the two countries are on the basis of 60 days bills and though yens are quoted for cable deliveries, the actual demand is for yens to pay for imports for which D. D. will do just as well. Similarly the supply of yens is only through buying 60 days bills on Japan a good proportion of which is 'house paper' of the big cotton companies such as the Toyo Menkwa

Kaisha.\* There is also a certain amount of T. T. business which arises from them. Japan is chiefly interested in cotton and silk piecegoods, the former as exports and the latter as imports. The yen business is therefore more active in Bombay though there is good demand in Calcutta and Rangoon where half the commodity enters. This is reflected in the rate for yens which are quoted in Bombay at  $137\frac{1}{2}$  T. T. selling and  $135\frac{1}{2}$  buying 60 days bills and in Calcutta at  $137\frac{1}{2}$  D. D. selling and  $134\frac{3}{4}$  for bills. The spread in Calcutta is therefore more than in Bombay.

The Japanese banks would also have tables of arbitrated rates for variations of the cross-rate in  $\frac{1}{32}$  d. and for rupees in  $\frac{1}{32}$  d. When selling yens, they would quote a slightly higher rate than that shown in the table and buy at a slightly lower rate. The method of calculating the yen rate is as below:—

If the cross-rate is  $24\frac{3}{4}$  and sterling is  $1/5\frac{3}{4}$  to  $1/5\frac{7}{8}$  then the selling rate is  $Y. 100 = \frac{24\frac{3}{4} \times 32 \times 100}{569}$  or  $137\frac{3}{4}$  and the buying rate is  $Y. 100 = \frac{24\frac{1}{2} \times 32 \times 100}{571}$  or  $135\frac{7}{8}$ . The actual rates would therefore be 138 selling and  $135\frac{3}{4}$  buying with closer rates for large amounts.

1. What is the equivalent of £133-6-8 at  $1/5\frac{3}{4}$ ?

$$£133-6-8 = £133\frac{1}{3} = £49^0 = 49^0 \times 240d. = 32,000d.$$

$$\text{Required number of rupees} = 32,000 \div 17\frac{3}{4} \\ = \frac{32000 \times 32}{575} = \text{Rs. } 1,780-13-11$$

2. What is the sterling equivalent of Rs. 1,780-14-0 at  $1/6\frac{1}{2}$ ?

$$\begin{aligned} \text{Rs. } 1,780-14-0 &= 1780 \times 1/6\frac{1}{2} + \frac{1}{2} \times 18\frac{1}{2} \\ &= 1780sh. + 890sh. + \frac{1780}{32}d. + \frac{1}{2} \times 18d. \\ &= £890-0-0 + £44-10-0 + 55\frac{1}{2}d. + 15\frac{1}{4}d. \\ &= £133-10-0 + 71d. = £133-15-11. \end{aligned}$$

3. What is the rupee equivalent of \$1,846.35 at  $276\frac{1}{2}$ ?

\$1,846.35	=	Rs. 1,846.35	at 100
		1,846.35	at 100
		923.175	at 50
		461.588	at 25
		18.463	at 1
		9.232	at $\frac{1}{2}$

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$$\begin{aligned} &\text{Rs. } 5,105.158 \quad \text{at } 276\frac{1}{2} \\ &= \text{Rs. } 5,105-2-6. \end{aligned}$$

\* J. Bouye, Problems of the Japanese Exchange, 1914-1926.

4. What is the yen equivalent of Rs. 1,72,345-12-0 at 134 $\frac{3}{4}$ ?
- $$\begin{aligned} &\text{Rs. } 1,72,345-12-0 \\ &= \text{Y. } 172,345\frac{3}{4} \times 100 \div 134\frac{3}{4} \\ &= \text{Y. } \frac{689,383}{4} \times \frac{400}{539} \\ &= \text{Y. } \frac{68,938,300}{539} = \text{Y. } 127,900\cdot37 \end{aligned}$$
5. Find the equivalent in rupees of \$2,431\cdot25 at 486 $\frac{1}{4}$  and 1/68 $\frac{1}{2}$ .
- $$\begin{aligned} &\$2,431\cdot25 \text{ at } 486\frac{1}{4} = \text{Rs. } 500 \\ &= \text{Rs. } 500 \times 240 \div 184\frac{1}{2} = \text{Rs. } \frac{500 \times 240 \times 32}{577} \\ &= \text{Rs. } 6,655\cdot113 = \text{Rs. } 6,655-1-10. \end{aligned}$$
6. What is the dollar equivalent of Rs. 1,843-12-6 at 274 $\frac{1}{2}$ ?
- $$\begin{aligned} &\text{Rs. } 274\frac{1}{2} = \$100\cdot00 \text{ or Rs. } 100 = \$36\cdot43. \\ &\text{Rs. } 1,843-12-6 = \$18\cdot4378 \times 36\cdot43 = \$671\cdot68. \end{aligned}$$
7. What is the rupee equivalent of Yen 1,745\cdot32 at 135 $\frac{1}{2}$ ?
- $$\begin{aligned} &\text{Yen } 1,745\cdot32 = \text{Rs. } 1,745\cdot32 \times 1\cdot355 \\ &= \text{Rs. } 2,364-14-6. \end{aligned}$$

## CHAPTER IX.

## THE MINOR EXCHANGES.

*"—and the rest nowhere."*

Francs—Australian pound—Marks—China—Straits Settlements  
—Siam—Java—Ceylon.

**Francs.**—The business between France and India is mostly confined to Bombay. Franc bills are, however, not very common though the Comptoir National has done its best to foster the business. Sterling bills for this trade are drawn on Paris just as frequently as on London and the 'French Bank' finds them very useful. There is some franc business at a spread between buying and selling rates which indicates the narrowness of the market. For example, on a certain day, banks were selling D/D at 914 and buying at 924 i.e. a difference of 1% which in sterling would amount to a difference of  $\frac{3}{17}$  d. in the rate, or three times what it is now. Francs are quoted in foreign units per 100 rupees and the buying rate is therefore higher than the selling rate and the 3 months' bill rate is still higher, the T/T rate being the lowest as in the case of sterling. But there is practically no demand for T/T francs either way. There is some arbitrage business but this

is based on franc bills bought in India, the proceeds of which are sold in Paris and the sterling is sold in India. The method of calculating the franc rate is as follows:

Paris cross rate 124.15, sterling  $1/5\frac{1}{4}$  to  $1/6$ .

Selling rate for francs is Rs.  $100 = \frac{100 \times 287}{16 \times 240} \times 124 = 927$

Buying rate is Rs.  $100 = \frac{100 \times 18 \times 124.30}{240} = 932$ .

The actual buying rates might be 925 and 935 though for large amounts, finer rates would be used.

**Australia** :—The Australian pound and the British pound are supposed to be same and ordinarily £100 of one country should cost the same in the other country. But if this were so, exchange business could not be carried on as the exchange banker must find a difference between buying and selling in order to pay his expenses. Hence at the best of times there would be a selling rate of  $\text{£}99\frac{1}{4}$  foreign currency and a buying rate of  $\text{£}100\frac{1}{4}$  for £100 local currency. But the state of trade and seasonal influences might move the rates a little more each way. During the last few years the Australian pound has steadily deteriorated so much that it is now quoted at 132 and the best efforts of the banks have proved of little avail in keeping it steady at any particular level.

The effect of quoting for cheques and 90 days bills is also different. If T. T. on Australia is quoted in London at 132, then the cheque or D. D. rate must allow interest for the transit time of nearly four weeks and if this amounts to a pound, the D. D. rate will be 133 and the rate for 60 days sight bills will be 135. In selling, the margin would usually be less, say,  $\frac{3}{4}$  point per month.

**South Africa** :—Exactly similar relations exist between the South African and the sterling pound, but the discount on the former has generally been steady at between  $\frac{1}{4}\%$  and  $1\%$ . The reason is that while Australia has heavy interest payments to make in London, South Africa has not, and very often the Reserve Bank of South Africa has substantial London balances. Exchange in London on South Africa being quoted at  $\frac{1}{4}\%$  discount selling, D/D is  $\frac{3}{8}\%$  discount, and 60 days bills  $\frac{3}{4}\%$  discount, making  $3\%$  interest, but in the case of buying, the

margins are wider. The spread between D.D and 60 days bills is  $1\frac{1}{2}\%$  discount or an interest charge of  $6\frac{3}{4}\%$ .

**German Marks** are not quoted in Bombay but only in Calcutta, as also in Madras. The mark business, however, is almost non-existent in India. Though marks are quoted both for D. D. and for 60 days bills, there is very little trade moving under mark bills. It is true that marks have been stabilised but they never enjoyed international popularity even in the heyday of their glory chiefly owing to the generally higher discount rate in Berlin and its proximity to London. Business with Germany is therefore financed almost exclusively through sterling though the German trade with India is nearly as large as the trade with Japan or the United States. But the dollar and the yen have fought a fairly successful battle with sterling. The mark is likely to lose further ground because of the recent collapse from 20.43 to more than 27. Marks are quoted in foreign currency and the selling rate is therefore lower than the buying rate. If the cross-rate is 20.43 and the sterling rate is  $1/5\frac{1}{8}$  to  $1/6$  the mark value of Rs. 100/- is worked out as follows :—

$$\text{Selling Marks} = \frac{100 \times 287 \times 20.40}{16 \times 240} = 152\frac{1}{2}$$

$$\text{Buying Marks} = \frac{100 \times 18 \times 20.45}{240} = 153\frac{1}{2}$$

The actual rates would probably be 152 and 154.

**China** :—There are two points of contact between us and China. The first is through the British Colony of Hongkong and the second through the international settlement at Shanghai. The currency of Hongkong consists of notes issued by the various banks which enjoy the concession, the chief of whom is the Hongkong and Shanghai Banking Corporation. These notes are also current in the interior of the country. The Hongkong dollar is, however, too closely allied to silver to be an independent standard of value. The ideal coin is to contain about 416 grains of silver, 900 fine or 375 grains fine silver, and its exchange value though not varying absolutely with silver, does move with it. When silver was sold in India at 56 rupees it was quoted in Bombay at 135, but when silver declined to 27 rupees *ex duty*, it is quoted at 70 instead of 65



as it should be, and when silver rose to 30 rupees it was quoted at 77 instead of 71 as it should be. The Shanghai tael is a unit of silver about 565 grains of fine silver and its value in rupees varies with the price of silver. The tael is not a coin but is bought and sold in shoes or "sycees" of 50 to 60 taels. The cumbersomeness of the procedure attaching to a purchase or sale of goods in terms of taels will be easily appreciated. For small purposes, there are what are known as "cash" but as these are only arbitrary pieces of copper, their value is not standardised. Between one province and another even now there are variations in the value of the cash and each is at a discount in another province. In fact, if without buying anything, one changed the cash sufficiently often, he would soon be left without any cash to change.

The Shanghai tael is equal to 1.178 ounces of fine silver. When silver in London is 12½d. and sterling in Bombay is 1/5⅞ the tael will be quoted at

$$\text{Tael 100} = \text{Rs. } \frac{565 \times 25 \times 40 \times 8 \times 100}{480 \times 2 \times 37 \times 143} = \text{nearly 89 rupees.}$$

The selling rate would then be 90 and buying rate 88.

**The Straits Settlements** have a dollar which is connected with the pound sterling by an exchange standard as in Indo-China. The Government sees to it that the dollar is maintained very near 2sh. 4d. and either sells sterling or buys sterling fairly freely according as the rate is too low or too high. The relation between the Singapore dollar and the rupee should therefore be the proportion between the sterling values of the two currencies, i.e., nearly  $\frac{2}{1} \frac{3}{4}$  or 155. It may vary between 152 and 158 in accordance with the actual value of the rupee and the Singapore dollar in terms of sterling.

**Siam** has an exchange standard currency and the tical is maintained more or less near 22d. At the present time it is quoted at about 125 rupees per 100 ticals but business with Siam is comparatively small and only in Calcutta is much interest shown in it.

**Java** uses the guilder which is maintained at parity with the Dutch florin. The florin is generally steady at about 12.11 per £ and the quotation on Batavia is also nearly the same.

The usual variations are from 12.05 to 12.17. The relation between the rupee and the guilder should therefore be nearly  $\frac{18 \times 100 \times 12 \cdot 12}{240}$  or 90¾ guilders per rupees 100. At 1/5¾ and 12.11, the rate should be  $\frac{71 \times 100 \times 12 \cdot 11}{4 \times 240}$  or 89½. We import our sugar chiefly from Java and as the sales are sometimes on a rupee basis, sometimes on sterling basis and sometimes on the basis of guilders, the importer will make suitable arrangements to pay for the bills which usually come through the Netherlands Trading Society and in some cases through the Netherlands India Commercial Bank or the British banks.

**Ceylon** has a rupee currency but the rupee is divided into 100 cents. The cent is a copper coin similar to the Indian pie in size. There are 5 cents in nickel, and 10, 25, and 50 cents in silver. The rupee itself does not circulate except in the form of notes. The Ceylon rupee is generally quoted in India at a discount of about ½ to 1 per cent, but if the Indian currency note is taken to Ceylon, it will usually fetch its full value. In the case of transfers of money however, the two currencies are supposed to be at par but the charge for drafts between Ceylon and India is higher than within the limits of India. We import only about 1 crore of tea from Ceylon but sell 13 crores of rice, coal, chillies and other products. Consequently Ceylon has always to buy Indian funds, which shows why there is a premium in general for them.

1. London on Shanghai being 2sh. 4½d. and Bombay on London being 1/6½ what is Bombay on Shanghai?

$$100 \text{ Shanghai taels} = 28\frac{1}{2}d. \times 100 = \frac{22500}{8}d. \quad 1 \text{ Re.} = 18\frac{1}{8}d. = \frac{145}{8}d.$$

$$100 \text{ Shaghai taels} = \frac{22500}{8} \times \frac{8}{145} \text{ Rs.} = 155 \cdot 17 \text{ or } 155\frac{1}{4}.$$

2. T.T. on Singapore in London is 27½ and Bombay on London is 1/5½.

What should be T.T. Bombay on Singapore?

$$100 \text{ Singapore dollars or Str. } \$100 = 27\frac{1}{2} \times 100d.$$

$$= \frac{445}{16} \times 100d. = \frac{44500}{16} \div 17\frac{1}{2} \text{ Rs.}$$

$$= \text{Rs. } \frac{44500}{16} \times \frac{16}{287} = \text{Rs. } \frac{44500}{287} = \text{Rs. } 155 \cdot 05$$

$$\text{The rate} = 155 \cdot \frac{1}{16} \text{ or } 155\frac{1}{16} \text{ to } 155.$$

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3. If T.T. on Hongkong is  $81\frac{7}{8}$  in Calcutta and on London is  $1/5\frac{1}{2}$ , what is T.T. London on Hongkong?

$$\begin{aligned} 100 \text{ HK. dollars} &= 81\frac{7}{8} \text{ Rs.} = \frac{655}{8} \times 17\frac{1}{2} d. \\ &= \frac{655}{8} \times \frac{143}{8} d. \end{aligned}$$

$$\therefore 1 \text{ HK. dollar} = \text{Rs. } \frac{655 \times 143}{8 \times 8} = 14.634 d. = 14\frac{3}{4} d.$$

4. The sterling pound being quoted in South Africa at  $\frac{1}{2}\%$  premium find the value of £6423-14-3 at  $1/5\frac{3}{4}$  T.T. on London.

$$\text{S.A. } £6423-14-3 = \text{S.A. } £6423.712$$

$$= £64.23712 \times 99\frac{1}{2} = £6383.563$$

$$= \text{Rs. } \frac{6383.563 \times 32 \times 240}{575}$$

$$= \text{Rs. } 85,262-2-8$$

5. What is the rupee equivalent of Fcs. 18,725.43 at 931?

$$18,725.43 \text{ fcs.} = \text{Rs. } \frac{18725.43}{931} = \text{Rs. } 2,011-4-1.$$

6. What is the francs equivalent of Rs. 225-6-8 at 929?

$$\text{Rs. } 225-6-8 = \text{fcs. } 225 \times 9.29 + \frac{9.29}{4} + \frac{9.29}{6}$$

$$\text{fcs. } 2,090.25 + 3.87 = \text{fcs. } 2,094.12.$$

7. What is the rupee equivalent of Java guilders 1,803.22 at  $91\frac{1}{4}$ ?

$$\text{The equivalent is } \frac{1803.22}{100} \times \frac{400}{365} = \text{Rs. } 1,976-12-3.$$

## CHAPTER X.

### THE EXCHANGE BANK.

*"We enter the golden gates."*

The functions of the exchange bank—The bank's margin—  
In other countries—Factors affecting it—Agency function—  
Organisation—Profit and loss items.

When a man buys a commodity from another, he must pay for it something which should satisfy the other party that he is receiving full compensation for the labour involved in producing it. This payment may be in the form of services or other commodities. In the first case it is the equivalent of wages or remuneration and in the second case it is the method of exchange for effecting which modern civilisation has evolved a system of prices or values of commodities in terms of standard monetary units. These units may be of

international value as in the case of gold or comparatively rare value like silver or of small value like copper. The system of paper currency is generally designed as an efficient substitute for these coins for making local payments in the country though we shall see that they may sometimes be sent to other countries. The monetary standard in the international world is not a coin or unit of currency but a standard weight of gold or sometimes silver. There are several methods of transmitting funds between one country and another so as to give creditors an acceptable form of payment and to receive payment of our dues from other countries and it is the business of the exchange bank to act as a clearing house of such transactions, buying from one and selling to another.

The exchange bank is the product of the modern system of international organisation. It specialises in the purchase and sale of rights to foreign currency and though the supply of exchange from one person will not be equal to the demand by another it takes them all together and offsets them but if at the end of the day it has a surplus or shortage of foreign currency, it either decides to carry it on to the next day, or if the amount is large, it buys or sells the extra amount from some other party.

In recompense for its work as a trader it makes a kind of service charge. The rate at which it buys foreign currency is not the rate at which it will sell it. In modern competitive business the difference between these two rates is not much and the exchange bank like other concerns depends for its profits not so much on the margin between buying and selling rates as on a large turnover. If the volume of business handled is large enough between two countries, the competition will be keener and the margin tend to become smaller. Thus the margin for sterling is usually  $\frac{1}{8}$ d. out of 18d. or '34% but for dollars it is usually 2 out of 275 or nearly '73%, in yens about 1 out of 135 or '74% and in francs about 10 out of 925 or 1'08%.

There might be other circumstances affecting the margin such as easiness of communication. For example, it is possible to get a reply to a cable from Bombay to London in a shorter

time than for one from Bombay to Calcutta. What is more surprising is that a quicker service is maintained between London and New York and there are special telephonic communications between London and important financial centres of the continent of Europe. In fact when both London and New York are working, a reply can easily be received in two hours. The bigger banks have special arrangements with the cable companies for rapid transmission of their messages. Thus the American Express Company has an arrangement with the Western Union Telegraph Company which has offices in all the important cities of the continents of Europe, America and Africa.

The margin would also depend upon the comparative stability of the two currencies. For example, when in 1920/21 the rupee broke away from 34 pence to 15 pence sterling within twelve months, no one could afford to work on small margins and the difference between buying and selling was as much as  $\frac{1}{8}$  of a penny and very often one farthing. But in ordinary times it is less and is usually  $\frac{1}{16}$  d. or even sometimes  $\frac{1}{32}$  d. Similarly because of the rapid fluctuations in the value of silver and therefore of the Shanghai tacl, the latter is quoted generally with a difference of more than 4% as compared with nearly  $\frac{1}{3}\%$  in the case of sterling.

Another instance of such variation is furnished by the recent happenings in Germany. Till about June the rate was quoted in London at  $20.39\frac{1}{4}$  to  $\frac{3}{4}$  or a margin of  $\frac{1}{16}\%$ . Owing to the disturbance of credit conditions there due to the uncertainty about the Reparations negotiations, the rate was for some time quoted at  $20\frac{3}{4}$  to  $\frac{5}{4}$  or a margin of over 1%. After the settlement with France by President Hoover, the rate has again begun to be quoted in the old manner.

Under present conditions when the foreign currencies are more or less stable, some idea of the margin in other countries can be obtained by comparing the next higher quotation. Thus in India, if a person does not like to buy at  $1/5\%$ , he would have to wait for  $1/5\frac{2}{3}\%$ . In other words the difference is  $\frac{1}{3}\frac{1}{2}$  d. or nearly  $\frac{1}{6}\%$ . In the rate between London and New York, from 486 $\frac{1}{2}$  the next quotation would be 486 $\frac{1}{4}$  or even 486 $\frac{1}{2}$ ,

which would be  $\frac{1}{80}\%$  or  $\frac{1}{180}\%$ . Between London and Paris, the next rate after 124'36 would be 124'38 or  $\frac{1}{80}\%$ . Between London and Amsterdam, the next rate after 12'11½ would be 12'11¾ or a change of  $\frac{1}{80}\%$ . In India, after the exchange was stabilised at 1/6 the banks have come to an agreement that no bank should transact business at "half rates" or  $\frac{1}{84}$ d. difference, for the same week's delivery. Thus if a bank was offering 1/6½ and the client wanted 1/6, the bank could not meet him by offering 1/6¼d. It would have to maintain its quotation of 1/6½ or give in wholly to the client. It might, however, buy half the amount for one week's delivery and half the amount for the next week. But it does not always suit the seller. If he is selling a bill, he could not sell it in two weeks unless he has made the shipments in two lots. In practice, therefore, half rates are not quoted.

In other countries the foreign exchange banks encourage their clients to keep foreign currency accounts so that they pay into these accounts all credits due to them in particular currencies and pay out of them amounts due to others. The banks make a small charge for maintaining these accounts but allow interest on them at somewhat better than the deposit rates in the foreign centre. Thus, though London deposit rate would be only 1% while current accounts there would not receive any interest, foreign currency accounts would be paid at and even 3% if the Bank of England rate were about 4%. When the clients send out bills, the proceeds are credited to the account and when they have to pay for bills drawn on them, the amounts are debited to the foreign currency accounts direct. The banks derive two advantages from this. They receive a commission charge which partly compensates them for the exchange profit, but the risk of exchange is taken on by the clients. Secondly, in most cases, this helps them to keep lower foreign balances of their own and when their own balances might turn their real foreign account into a debit one, these would help to make it a credit one and save interest charges. In view of the manifest advantages to all parties, it is to be hoped that banks here will also adopt this system.

The exchange bank performs another function which is of

*greater importance.* The exporter under ordinary circumstances would have to send his goods to the foreign buyer and have to allow him 60 days or 90 days credit but would also have to wait for the period of transit of the goods and for the money to be remitted back to him. In the case of India and England, this might take four months, but the exchange bank buys the bill from him, pays ready cash, and compensates itself by deducting interest for the period. It acts as agent for him in collecting the proceeds of the bill and in protecting his interests abroad. It performs similar services on behalf of foreign clients. If the foreign exporter desires payment before he parts with his goods, the exchange bank is there as the importer's agent to pay for the documents when the goods have been shipped.

The exchange bank performs the function of selling and buying "forward." Thus if an exporter is thinking of sending out goods some time later, he might like to be sure of the rupee amount he would receive for his goods. As the prices are quoted in sterling, he has to know at what rate the bank will buy a bill from him some months later. The exchange bank takes up the risk and promises to pay him on the date at an agreed rate. Similarly if a person wants to import goods, the exchange bank would agree to sell him the sterling at the time desired, and assume the risk itself. There are several other incidental services which an exchange bank performs but its chief business is the buying and selling of the commodity known as "foreign exchange."

An exchange bank usually has three important officials with others to help them and act as substitutes if necessary. There is first the manager who looks after the organisation, general supervision and relations with other offices and correspondents. Then there is the exchange operator who has to look after the clearing of the purchases and sales of exchange in the various departments. Then there is the accountant who looks after the money side, current accounts, and office supervision. The exchange operator may often be the assistant manager in which case office supervision would be his work. The accountant will have to see to the cash resources and

*follow the status of the balances of the bank with other branches and correspondents, as also with the local banks ; he would have to see that contracts are taken up on the due dates, in fact, he should be a sort of legal remembrancer to the bank.*

There are usually several departments in the exchange bank in addition to those found in domestic banks. Besides the cash, accounts, current accounts, securities and credit departments there would be the following :—

Outward Bills Department

Inward Bills Department

Exchange Department

Mail and Cable Transfers & Drafts Department

Cable Department

Credits Department

Outward bills are bills covering exports from India which the bank purchases from clients or takes for collection. This department will have to follow the fortunes of each bill and to see if proceeds have been credited on the proper dates and if not received, take up the matter with the branch or agent concerned. The inward bills are bills received from other offices and agents for collection in India. When the bills are paid the foreign currency amounts should be remitted if the bills were sent by other banks and credit advices should be sent to the clearing office if they were sent by a sister office. The exchange department will see to the details connected with the exchange purchase and sale contracts and keep track of the foreign currency positions. It will work more or less directly under the exchange operator. The cable transfer department will send instructions to foreign offices or agents to pay amounts sold in India to remitters by cable or mail, and to receive payments abroad of purchases in India. The department will also have to make payments in India for which instructions may be received from abroad. It will also issue drafts on foreign centres for local clients and Letters of Credit for travellers, and see that offices concerned are advised of their issue. The cable department has to arrange to send out cable transfer messages which are always sent in special code language. It will also have to decode



messages received from other offices. It will code and send out messages for other purposes such as to enquire about the fate of a bill or for the purchase or sale of some foreign currency amounts for arbitrage purposes. For this purpose most banks use their own special codes though some use Bentley's or A. B. C. and the cipher code. In any case there will be some secret words for messages authorising payments of money to other persons.

The credits department is concerned with opening Letters of Credit for importers and advising those received for exporters here. It will keep track of deposits made by importers and of bills received against the credits issued for them. It will keep in touch with the credit department which collects information regarding local clients and firms and customers abroad. In practice the two departments may often be run as one. The Letters of Credit may be issued by mail or by cable in which case a coded message will be sent to be followed by mail confirmation. The message will be authorised by special secret words as a credit is the same as a payment of money to others. The working of the other departments is as in local banks and it is not necessary to describe them here. While the volume of current accounts in an exchange bank will be as large as in domestic banks of the same size, its security department will be comparatively inactive. Its cash resources need not be as high as domestic banks as its clients generally draw cheques in favour of parties who send them for clearing and do not present them over the counter.

The following are the profit and loss items of an exchange bank :—

*Earnings*

- Interest on loans and cash credits
- Interest on foreign balances (credit)
- Interest on investments
- Interest on local bills discounted
- Interest on overdrafts of sister offices
- Exchange profit
- Commissions on collections
- Commissions on acceptances
- Commissions, miscellaneous

Rent on promises let or sublet.  
*Miscellaneous earnings.*

*Expenses*

(a) *Trading Account*

Interest on loans  
 Interest on foreign balances (debit)  
 Interest on overdrafts in local banks  
 Interest on capital  
 Interest on current accounts and deposits  
 Interest on credit balances of sister offices  
 Commissions paid  
 Brokerage  
 Loss due to bad debts etc.  
 Miscellaneous expenses.

(b) *Operating expenses*

Salaries, pensions  
 Travelling expenses of officers  
 Rent  
 Advertising  
 Printing, stationery, postage  
 Telephone and telegrams  
 Income and other taxes  
 Insurance  
 Depreciation  
 Legal expenses  
 Miscellaneous expenses.

## CHAPTER XI

### THE EXCHANGE OPERATOR.

*"Number engaged please"*

The operator's work—How business is transacted—The broker—  
 Brokerage—The exchange position—The dealer's qualifications.

In an exchange bank a very important position is that of the exchange operator who is entrusted with the work of looking after the clearing of exchange purchases and sales. He is called the "dealer" in England and America but there is no definite name for him in India. He is sometimes called the operating official but this is in contrast with the administrative official. Generally the work of the dealer is left to the assistant manager though the manager himself may also do it. To him would come all the results of the minor transactions in the

various departments of the bank. All the major transactions would pass through him. What exactly is a major operation depends on the volume of business the bank handles but about £1000 would be the limit. If it is a question of purchasing an *export bill*, the outward bills section would fix up small amounts but, for larger amounts, the exchange operator would have to fix the rate because he has to sell the exchange against them and to decide whether the delivery proposed would suit him. For example, if he has sold December T. T. an October bill would not be as attractive as a November bill for which he might be prepared to give a better rate. Similarly when a large-sized inward bill is to be retired or an anticipated bill has to be provided for by a contract, the rate must be settled by the exchange operator.

Once or twice in the day, the exchange operator gets information from all the departments of the total business dealt by them. The outward bills section would send the total of small bills purchased with the time of delivery and the usance. The inward bills section would send him the total of bills retired or contracts made for small bills. The cable transfer department would send him the totals of demand drafts sold, cable and mail transfers sold and the demand drafts purchased. The exchange operator keeps before him the schedules of all these sales and purchases and of his own transactions. He would check up his exchange position pretty often to ascertain the uncovered balance, whether overbought or oversold, and if the amount is large, he would try to dispose of it.

The dealer does not himself get in touch with the clients or the banks. He always uses the services of brokers who are only intermediaries and do not buy or sell the exchange for their own account as in some other countries. These brokers go round every day in the morning as soon as the banks open and ascertain their public buying and selling rates and also if they have an over-night position to clear. Sometimes the balance to be cleared is not very big and the bank might give the broker an order to close *at best* meaning that it would be prepared to take the best the broker can secure, which would, of course, not be worse than the middle rate, but it would

expect him to get the open rate if possible. He would also be told the rate at which the banks would be willing to do special business in large amounts. The broker in calling round the banks would mention the offers he has on hand but would not mention the name of the bank which is selling or buying. If he finds that a deal is possible the rate is fixed and he then gives the name of the bank and gives each of the two banks a provisional memorandum stating whether it has made a sale or purchase, whether it is ready or forward, the delivery agreed upon and the rate. From his office the formal contract would be sent out in the course of the day on stamped paper. He is allowed a commission of  $\frac{1}{16}\%$  by the seller and this accrues in the books until the end of the month when he is paid in one amount.

He may often have requests from private parties for their purchases and sales and if these would suit the banks he would make the contracts with them forthwith. As the broker has no exchange position of his own, he has to get what are known as "firm offers" and the parties should give him time to go round and find the buyer or seller as desired with authority to complete the transaction. Otherwise, before he could return to the original client and obtain his consent, the other party might have changed his mind and might make the broker go over the ground all over again. With a firm offer in hand he is in the position of the client himself and can act fully as his agent. Sometimes, however, two or three brokers may have the offer and the clients would be anxious to accept the best offer they could bring and it is the other parties that would have to give the brokers the firm offers. In these cases the clients are taking the risk of the business not being put through owing to the brokers not having firm offers.

As soon as they have gone round the banks or sometimes even after they have gone to three or four important ones, the brokers would ring up their clients and tell them the rates at which business has opened, and might get orders to buy exchange or sell bills with limits as to the rate. They would then call round the banks again with these offers and make them to the banks one after another. During the first round

*they might have gauged the banks that would like a particular kind of transaction and they would approach them with the business if they had it on hand. If an enquiry is made, they would not give out the name of the client but would guarantee that the party was a first class one, or a responsible party or as normally good for engagements. If the offer is accepted, they would give the bank the name of the party. Sometimes the bank may not desire to accept business even from the best parties as it might have had too many outstanding dealings with them. It might have other grounds to decline the business. The deal is therefore only finished after the bank has been advised of the name and it has been accepted by it. Even then the brokers who have made deposits with the bank are to a certain extent responsible for the proper fulfilment of the contracts that they put through. The bank has thus an additional guarantee for the performance of the contract.*

The broker knows who the buyers and sellers are among ordinary clients and among the banks but, as ordinary clients will not do business with each other for reasons we have already explained, a bank has necessarily to be the medium for clearing the transactions. The broker, however, is only a matchmaker. He knows where possible bridegrooms are and where the brides are but his interest in the marriage is merely his commission and the necessity of keeping up his reputation. The terms of the marriage are settled by offers and negotiations by the two parties but the broker is not concerned with the exact terms of the match. Hence it is that often-times we find the broker entering a bank with an offer to sell in one hand and an offer to buy in another hand. And the bank gets an agency fee for clearing the two transactions of which it pays a part to the broker for introducing the business.

It has always been the tradition among bankers in India that it was a point of honour *not* to approach a rival with a direct offer to buy or sell sterling. Consequently, it was considered a sort of necessity to employ a broker to go round and fix up the bargain. A banker in India would no more think of doing without the broker than a lord would think of doing without the butler or a barrister without the solicitor. In New

*York it is not considered beneath dignity to approach the banks directly but the tradition in India is otherwise. Even when the business is transacted after banking hours, some broker's name is put in and he is paid the brokerage.\**

In India most business houses have connections with the banks through brokers of their own nationality. It is rarely that a European firm engages the services of Indian brokers though Indian houses often use European brokers, the reason being, whether justified or not, there is a feeling that they would be able to have better access to the exchange operators and thus secure better rates. In Bombay probably almost all European firms send their business through European brokers and almost all Indian houses utilise the services of Indian brokers, while in Calcutta, most of the business is in the hands of three or four European firms.

The imports into India of gold and silver average about 30 crores per annum and as this business is in the hands of Indian merchants in Bombay, it is passed through Indian brokers. There is a good proportion about 20% of ordinary import and export business in Indian hands and this also is mostly done through Indian brokers. About 50—60% of the foreign trade is handled by European firms through banks and almost all of these are handled through European brokers.

So long as exchange business was giving very good profits the brokerage of  $\frac{1}{16}\%$  did not matter. But there came a stage when, though the published differences between buying and selling was  $\frac{1}{16}d$ , the actual difference in some cases arose through a transaction with an outside party being offset by inter-bank business, which was always at the middle rate. The banks' profit became thus reduced to  $\frac{1}{32}d$ . and brokerage at  $\frac{1}{16}\%$  amounted to nearly  $\frac{1}{2}$  of the profit in the rate and ate considerably into it. The banks therefore came to an agreement with the brokers that they would give them  $\frac{1}{16}\%$  or full brokerage on business with outsiders and only  $\frac{1}{32}\%$  on business between the banks themselves. But though it was feared that some of the European firms of brokers would have to dispense

\*Hugh F. R. Miller, *Foreign Exchange Market*, page 69.

*with some of their staff, no such thing was done and they have continued to thrive on the half rates.* \*

The original sale of sterling bills and cable transfers and demand drafts for financial operations in India is not under 250 crores and as these are sold by private parties there is brokerage at  $\frac{1}{8}\%$  on these amounting to  $15\frac{1}{2}$  lakhs. Excepting a maximum of 50 crores sold to the Government almost all the rest of this is resold to other banks or to the importer clients of the banks which buy these amounts. Commission on this would be only  $\frac{1}{8}\%$  on 200 crores or  $6\frac{1}{4}$  lakhs. Then there are the sales of the banks which desire to change their exchange position or to move funds to and from London. The amount of such sales would not be less than 100 crores and brokerage on this at  $\frac{1}{8}\%$  would be  $3\frac{1}{8}$  lakhs. The total brokerage paid will thus amount to about 25 lakhs, or at a very conservative estimate, 20 lakhs. Of this amount it is doubtful if even five lakhs goes to Indian brokers.

The exchange dealer has to look out during the day not only for covering his own transactions but he has to keep in touch with the cash position of the bank. While his operations might be fully covered even for the various forward deliveries, the cash position becoming short might require a 'budlee' of a forward sale to a ready one or the bank might have received large amounts of rupees somewhat unexpectedly and it would be the business of the exchange operator to do 'budlee' to bring the forward purchases down to ready. He would of course have to keep before him the position sheet of the various foreign balances so that in buying or selling ready, he could use his judgment to decide whether it is better on the whole to borrow here than sell ready or be overdrawn abroad than buy ready.

The exchange operator has an exchange position sheet before him drawn up somewhat on the following lines. Some operators do not take the purchases and sales of T. T. as shown here, on the assumption that D. D.'s are fairly balanced in sales and purchases. But this is not correct as the bank generally sells more D. D. than it can buy. The D. D. is converted into T. T. value by adding on Rs. 230/- per £10,000 bought or sold. Similarly bills would be reduced to T. T. value

by adding on the market spread between T. T. buying and bill buying rates. If this rule is not observed the operator will be giving away profits if his position is undervalued or make a loss if his position is overvalued:—

Table 11—Exchange Position sheet of the exchange operator.

			BOUGHT		SOLD	
			Sterling	Rupees	Sterling	Rupees
<b>SPOT</b>						
	B.F.	...	...	200		2,671
	Cable transfers	...	27,300	364,685	35,000	468,575
	D.D. at T.T. rate	...	7,658	102,323	13,450	180,120
	Bills at T.T. rate	...	15,650	209,278		
<b>FORWARD</b>						
	Bills at T.T. rates	...	38,000	508,138		
	Cable Transfers	...	17,800	237,816	61,000	816,260
<b>TOTAL</b>			...	106,608	1,424,911	109,450
					1,464,955	
Oversold/overbought					2,842	40,044
Bought/sold			...	3,000	40,140	
Overbought/oversold			...	158	96	
Value			...	158	2,106	
Profit			...		2,010	
London balance			...	27,343 Cr.		Dr.
Day's operations			...	34,958	48,450	
Balance			...	13,851		
Forward position					15,000	
Day's operations			71,450		61,000	
Oversold/overbought balance					4,550	

At the end of the day he clears his position as far as possible and during the day he would have tried if possible to reduce his uncovered forward position by conversion to ready. Of course he might be deliberately creating an open position in his forward contracts on account of his outlook for the future in which case he would leave it uncovered.

The danger of keeping an overbought or oversold position will be appreciated when it is understood that the usual difference between the banks' buying and selling rates to outsiders is  $\frac{1}{32}$  d. Thus if the selling rate is  $1/6\frac{1}{32}$  the buying rate will be  $1/6\frac{3}{32}$ . When a bank sells to another or buys from



another, it expects a rate better than the ordinary public and as the movement in the exchange rate is only  $\frac{1}{32}$ d. the business will be done at  $\frac{1}{6} \frac{1}{16}$ d. Since the rate of purchase of bills from the clients is the equivalent of  $\frac{1}{6} \frac{3}{32}$ , the buying rate, the margin of profit to the bank is only  $\frac{1}{32}$ d. And, as a seller, it has to pay brokerage. If, therefore, it keeps an open position and the rate should go up over-night, the next day's rate for buying might be  $\frac{1}{6} \frac{1}{8}$  from the public and the inter-bank rate  $\frac{1}{6} \frac{3}{32}$  which is the rate at which the bills were bought the previous day. Thus the bank cannot expect to make any profit but it must, in addition, bear the brokerage on the sale. Similarly the usual sale to clients will be at  $\frac{1}{6} \frac{1}{32}$  and the bank could have bought the sterling at  $\frac{1}{6} \frac{1}{16}$ , making a profit of  $\frac{1}{32}$ d. But if it should wait it might find that the rate has moved down over-night and that the rate for sale to the public is  $\frac{1}{6}$  and to banks will then be  $\frac{1}{6} \frac{1}{32}$  the rate at which it has sold. It can then make no profit on the transaction. If it should hold on to its 'position' in the hope that it could still find some clients to whom it could dispose of it, it might find that there has been another movement in the rate which makes even business with the public unremunerative.

The exchange operator should keep himself in active touch with the supply and demand of exchange, with trade movements, with crop forecasts and international factors tending to influence the competition with Indian products. He has to know the state of the London money, capital, stock and other markets and if he is interested in dollars or yens, the condition and prospects of the markets in those centres. He will have to keep himself posted in regard to the international price movements and tendencies and the fiscal and monetary policies and activities of the Government of India. He has to keep himself alive and alert and prepared always to take advantage of situations and initiate prompt action whenever needed. He must be quick and accurate in making calculations. He would have to know all about exporters and importers and he must be prepared to assist his clients with advice and guidance. He is generally an advance sales agent on behalf of his country and he must lose no chance of pushing its goods for he depends for his

success on the promotion of trade with it. He must indeed be a "live wire", quite up-to-date with information about everything relating to his business.

## CHAPTER XII.

### THE LONDON BALANCE.

*"It is his stock in trade."*

An analogy—The London account—Credit items—Debit items—  
Position sheet—Weekly statements and reconciliations—Value  
date—Other balances—'Loro' accounts.

A domestic bank which has a certain volume of deposits outstanding finds that though the total may be large it will not require the whole amount with it in cash and that while it will have to pay cash for cheques there will also be money paid in to the credit of other persons. Thus while the total deposits may be 70 crores and the daily volume of turnover may be about 1 crore it will not require more than a few lakhs as cash in its till. The idea is that all the payments will not come in at one time but though the total of withdrawals from deposits during a day will be nearly equal to the total of payments into the accounts, these payments out and in will not coincide and the bank should have some of its own money to pay when it does not come in as rapidly as it goes out.

The position of the exchange banker is exactly the same with regard to his dealings in foreign currencies. If he deals in sterling, he will find that, over a period, his receipts and payments of sterling will almost exactly balance each other but there will be occasions when he will have to pay out more than he receives and sometimes receive more than he pays out. He would therefore have a minimum London balance with his agent there from which payments may be made for his account and into which funds will be paid for his credit. It may not be necessary that this account should always be in credit, just as it is not necessary to have money in your account if you want to withdraw money from the bank. What you want is that the bank should be prepared to allow

you to overdraw the account and for the exchange banker the right of overdraft in London would serve the same purpose. Similarly he would have balance and overdraft arrangements at each centre on which he buys and sells foreign currency.

We have seen that the most important currency in which we deal is sterling. Consequently from the exchange banker's point of view, the most essential thing is to have a London office or agent on whom he could depend to carry through the other half of his transactions. If he buys an export bill, the presentation for acceptance, the receipt of payment or discounting it and all business connected with it in London will have to be transacted on his behalf by the London agent. If he is to get import bills they must be paid for or received for collection by the agent. If he is to open a credit, he must have a London agent to do so. To facilitate exports he must have a London agent who would issue credits on behalf of the importers in London or other places. He has to make payments by telegraphic transfer or to receive money by cable and his London agent has to look after this business. He may receive drafts for collection and these must be presented in London to the drawees. He may have to draw drafts in sterling and a London agent is an essential part of it. Similarly if he is dealing in dollar business, he must have a New York office or agent. If he is dealing in yens he must have an agent or office in Tokio or Yokohama.

Into the foreign account will be credited all amounts received for him and proceeds of all bills remitted by him. Against it will be debited all amounts paid on his behalf and all commission charges and other items relating to the business. He must therefore maintain it in credit as far as possible because, though on his credit balance he will get only a low rate of interest, if it should run into debit, the charge on the debit balance will be at a much higher rate. Thus on his credit balance he may get by special arrangement the rate at which call money can be loaned i.e. 2% below the bank rate. But on his overdraft, he will be charged bank rate, often with a minimum of 4%. The difference, therefore, between being in credit and being in debit means a substantial item in the

*result of his operations. On the other hand it may be that his funds in India would cost him more and he may find it advantageous to be overdrawn in London than to borrow in India. But there is a limit to the extent of his borrowing in London. The funds at the disposal of the London office which are available for lending to him depend on its total resources and as the London office has important relations with all the other offices over the world the proportion of credit at the disposal of one office must be limited. In the case of British banks however it is possible that the London office could lend its credit instead of its funds, i.e., it may accept the bills drawn by its Indian office or it may have arrangements with another bank to accept the bills drawn by it. The proceeds of these bills when discounted will be available for the Indian office. There is a limit to the extent to which this form of credit can be given because the London discount market will not accept paper of any institution indefinitely. Moreover, if the London branch accepts bills drawn by its own offices, the security behind them becomes much less than if the drawer and acceptor were different.*

Very often import bills into India are debited to this account by the sister offices as soon as purchased. This means that the Indian office has to provide for the possibilities of such debits but as the volume of imports into India is fairly well regulated and the office knows approximately its share of the business, it can generally have a fairly correct idea of the time and amount of such debits. Similarly when issuing a commercial credit the Indian office will not know exactly when the London office will pay for the foreign exporter's documents and have to be prepared with enough credit balance in London to meet the negotiation of the documents.

The actual London balance, therefore, is a matter of very great importance to the Indian branch. If it so likes it may arrange with the London office to have a cable sent once in two or three days advising it roughly of the state of its account in London. But the cost of such cables would be an unnecessary expense and if it can obtain the same information from its own records it would be quite as satisfactory. It

therefore maintains what is called a "position sheet" which gives an approximate figure corresponding to the state of the London account. In this 'position sheet' it tries to maintain as accurate a record as possible of the happenings in London. When it sends out a cable requesting payment, it will make a debit at once in the position sheet and similarly it will pass a credit when it buys T. T. on London. In the case of demand drafts which is has forwarded to London it allows 15 days for presentation and realisation. So the credit in the position sheet is made with a date 15 days ahead for the total of these drafts. Similarly if it has issued drafts on the London office or on other offices in sterling, it will debit the account 15 days ahead with the total of them all.

If it has purchased D/A bills on London which it intends to have discounted, they would be treated in exactly the same way as demand drafts. But if they are D/P bills or continental bills then it will have to keep them in portfolio and it will credit them to the position sheet as of the probable date of payment. If it has sold or bought forward exchange, debits and credits are shown on the corresponding dates. It has thus a fairly clear idea of the probable position of the London account. As soon as the day or week is over it strikes out a balance and carries it forward to the next sheet and this is carried forward similarly to the next one.

The London office usually sends out a weekly statement of account if the turnover is heavy ; but, if not, it will send out a monthly statement of account. The reconciliation of this account is a very important item in the bank's work because it may show credits which the bank is not expecting or it may show debits which the bank has to take notice of. It may also reveal some difference in the amounts credited or debited. If the differences are due to the local office they will have to be adjusted locally. If there is any doubt the point must be raised in correspondence and cleared. It may also happen that inadvertently an amount that should have been passed to the account of another office is erroneously passed to its account and this will have to be taken up by correspondence with the London office.

When the reconciliation or indentification of the items is over and the outstanding differences taken out, the Indian office will be able to readjust and correct the position sheet in the *light of the differences*. As, however, the position sheet is intended to reflect the state of the account *only roughly*, small items could be left out of consideration. Thus if the average balance is about £50,000 the bank need not worry about items less than £100.

The importance of the 'position sheet,' which is to indicate whether the Indian office is in credit or in debit, becomes greater if the account goes into debit as there is a danger of the overdraft coming near the limit settled for it. If the London agent is the bank's own office then this limit may sometimes be exceeded. But if it is another bank, though small excesses may be allowed, large amounts above the overdraft arranged for may not be paid. To provide for this, the Indian office should always be careful in seeing that the London balance never approaches dangerously near the limit. Even if the limit is not reached, the Indian branch would find it profitable to be in credit as far as possible. Some periods of debit are unavoidable and even profitable if the Indian rate makes borrowing here more costly than in London. But the usual position is that borrowing is more costly in London even with its own sister office as bank rate will be charged while funds in India could be got for the major part of the year at better rates. The interest charge in London could therefore be avoided by carefully watching the position and adjusting operations in India accordingly. In general, during the busy season the exchange banks find it cheaper to be overdrawn in London, and to keep the account in credit in the Indian slack season. In recent years, however, the attractiveness of the Treasury Bills in India has prevented this temporary flight of capital, though the Government have to pay fairly high interest rates to achieve this object.

Sometimes advices are received by the London office of debits or credits to be passed to the Indian office as of a date several days prior to receipt of advice. These items are entered in the statement of account with a note that for purposes of

interest calculation the items will be considered as having been passed on the dates desired, that is, a "*value date*" is shown against these items. Where the amounts are small, the value date would not very much affect the position, but if they are substantial they may sometimes turn a credit account into a debit account. Even otherwise, the interest on the amount would have to be calculated as if the entry has been made on the value date shown.

The accounts with foreign offices are sometimes called "*nostro*" accounts or '*our*' accounts. Similarly foreign offices might maintain rupee accounts which are called '*Loro*' accounts or '*their*' accounts. These accounts are debited with payments in rupees made on their behalf and credited with amounts received in rupees. If a sterling bill from them is paid in India, this account cannot be credited but sterling credit should be given through the London office. Similarly debits for sterling bills etc. sent should not be made into this account but credit should be claimed with the London office. Confusion must necessarily arise if the principles of operating the "*nostro*" and "*loro*" accounts are not properly understood.

These accounts may sometimes be with other banks or correspondents or for their behalf. The working of these accounts is like that of branch accounts except that other banks would not generally allow overdrafts and even if they do, they may not exercise discretion in allowing overdraft limits to be exceeded. A branch would certainly allow it and then protest if the excess continues for some time. Authority to open such accounts are granted by the head office which takes into consideration the credit reports on the banks and decides on a limit up to which balances may be maintained with them and authorise the banks to give the overdraft up to an agreed limit.

In the case of the Japanese banks there is some difference. When the Kobe office buys bills in India, it does not debit the Indian office but sends it on its own account and the business of the Indian office is to collect it and return the proceeds by buying a yen bill on Japan for cotton moving from India. These bills are not credited to the account of the Indian offices but are treated as returns of the funds sent out originally. The

profits of the Indian branches then arise from the rates at which they buy and sell yens here. When, however, the Indian branches buy or sell T. T. these would be passed to their account and dealt with accordingly. The position sheet is not therefore of such great importance to the Japanese banks as to others.

The Japanese bank would have to maintain an active account with the London office. The American bank would have a very active account with both the New York and the London offices and so would the 'French Bank' in London and Paris. The Dutch banks would have accounts with Amsterdam and London. The London balance to all of them is as important as the balance even with their head offices.

## CHAPTER XIII

### TRANSFERRING FUNDS.

*"Quick as lightning, slow as snails".*

Methods of transferring funds—Methods of remitting—Methods of bringing in funds.

If a person has to remit sterling to London, he has several options as to the method of doing so. They are enumerated below :—

1. Sending a cable transfer.
2. Sending a sight or demand draft or mail transfer.
3. Sending bills payable after a period.
4. Sending bills on other countries.
5. Sending gold.
6. Sending British currency.
7. Borrowing in London temporarily.
8. Asking the creditor to draw on him.

Similarly a person with London funds could transfer them to India by :—

1. Selling a cable transfer on London.
2. Selling a sight or demand draft.
3. Selling a bill payable after some time.
4. Selling the funds through another currency.
5. Buying gold or silver and importing it.
6. Borrowing in India temporarily.
7. Importing Indian currency.
8. Asking the debtor to remit.



**Sending a Cable Transfer :—***A cable transfer is an order payable by wire. In the inland postal system we have such payments which are known as Telegraphic Money Orders. The party desiring to send a cable transfer approaches a bank which tells him the rate at which it will sell the London funds and the cost of sending the wire. Payment in London is made as soon as possible after the wire reaches London. This is the quickest and therefore the costliest form of remitting. The applicant has to fill in a form like the following :—*

Blank Bank,  
Bombay.

Bombay,  
17th May, 1931.

Gentlemen,

Kindly effect the following payment :—

Payee.....John Smith  
Address.....100, Poplar Avenue, Suburbia, London  
For account of ..... James Jones (not to be telegraphed)  
Amount.....£75-10-0 (say Pounds seventyfive shillings ten)

at 1/6 exchange	...	...	Rs.
cable charges	...	...	Rs.

I am paying cash herewith.

This cable is sent on the express understanding that neither the Blank Bank nor its agent shall be held liable for any losses or damage occasioned by delays or errors in transit or in identifying the payee or any other cause beyond the bank's control.

Yours truly

...

(Sd). James Jones.  
72, Goa Street, Bombay.

The banks generally have a world-wide set of correspondents but in some cases the cables are sent to the principal monetary centre in that country and thence by post to the town or village or by telegraph to the towns where so requested. In the latter case, the remitter has to leave a deposit for internal telegram charges to be adjusted afterwards.

**Sending a Sight Draft :—**If the money is not required so urgently he could purchase a sight or demand draft and send it on to his friend. A sight draft is an order drawn on someone

*London* (or other foreign centre) asking him to pay the amount noted on it to the purchaser on presentation. It may be drawn by a private person or it may be drawn by a bank on its London branch or agent and is termed a bank draft. As payment in London is made after about 15 days after payment in India, the sight draft is cheaper than the cable transfer. For the ordinary remitter a bank draft is the most reliable form of remittance as he has the security of a credit institution behind the draft. But his friend to whom he remits may have some difficulty in making the proper endorsements and in identifying himself or in selling it to suitable buyers. To facilitate the sending of small amounts abroad the American Express Company of New York instituted a system of International Money Orders which have become now so well known that they can be cashed in almost any part of the world. This has been of great service to immigrants in the United States and small remitters in other countries.

For remittances to Britain there is a system of postal orders issued by the Post Offices throughout India. These orders are sold at a rate of exchange published from time to time together with a charge known as *poundage*. But as they are available in very small amounts down to six pence they are naturally popular as against bank drafts which will not be sold for small amounts. The reason is that the bank draft involves an amount of labour for which it has to compensate itself but the Postal Order is settled without difficulty by adjustments between the two Governments.

**Sending a Mail Transfer** :—Instead of sending a demand draft to the friend, it is sometimes convenient to arrange with a bank to make the payment by mail advice. The application is made just as for cable transfers and a small charge is made for the bank's responsibility in making the payment to the proper person. The bank requests its agent or branch in the other place to effect the payment and when the payee's receipt arrives it is sent on to the remitter just as in the case of the Post Office Money Orders.

**Sending Bills payable after a Period** :—It may be that the agreement is to pay the creditor after some months. In this

case the remitter can buy a bill for the requisite amount, payable on the proper date and send it on to his creditor. As payment in India is made now, but in London some months later, the bill will be much cheaper than the sight draft. These bills are known as time bills or usance bills or just *bills*. If the bill is drawn on private persons, it is a trade bill and, if drawn on a bank, it is a bank bill or bank acceptance. If the creditor finds he wants the money earlier, he can take it to a discount house or a bank and obtain its value less interest for the period of waiting.

**Sending Bills on other Countries** :—It may be that a bill on London is not available for some reason but a bill on Paris may be available. The remitter could buy it and send it to his creditor who could sell it in London and realise the sterling amount due. Of course, the remitter in this case will have to provide a margin so that his creditor may get the desired amount. If the payment is to be made in a country with a different currency from that of the bill, it is best to send a sterling bill as it can be easily sold for local currency.

**Sending Gold or Silver** :—Gold is the medium of international value and stable in its relation to the pound sterling and most of the important currencies. The remitter could send the gold to London and after selling it either in the open market or to the Bank of England, use the proceeds to pay the creditor. This method is often more costly than the others but it sometimes happens that the scarcity of London funds and the high cost at which they are sold make sending gold cheaper. But apart from the fact that the operation is a highly technical one, success depends on the size of the remittance and for one who wanted to send a small amount it is out of the question. The methods of moving gold are referred to in detail in a later chapter. Silver may also be used for this purpose, particularly to countries where the currency is silver.

**Sending British Currency** :—British currency notes are legal tender value in England and popular in several continental countries and are therefore sent into and out of England almost continuously. There is usually a brisk trade in British currency notes particularly in Bombay. Most tourists and foreign

residents in India and also Indians going abroad leave through Bombay. There are two specific seasons for such traffic, one known as the 'busy season' and the other as the 'slack season'. In fact most steamship companies have got two sets of rates for passengers for the two seasons. The busy season commences somewhere about the end of January and ends about the middle of August. The off season starts in August and ends in January. The busy season for India is generally the off season for people returning from Europe and the off season is the busy season for them. Tourists going out of India have to pay their bills on the boats in sterling and in passing through Europe the best form in which to take money which can be readily converted into local currency is the Bank of England note which is available even in ten shilling denomination.

The international value of the British pound note therefore makes it very popular with the tourists leaving Bombay. Similarly tourists arriving in Bombay come with some amount of notes. The notes from the incoming tourists are bought in India at a price slightly under the exchange value minus the cost of postage and insurance to London. Thus, if the exchange value is Rs. 13/7 per £, postage and insurance which are estimated at half an anna will be deducted and the notes bought at Rs. 13/6. But these notes cannot usually be kept for the Indian busy season on account of the loss of interest during the period of 6 months. They are generally sent off to London though of course there will be some demand for them even in the Indian off season.

When the busy season commences, the needs of outgoing tourists are far greater than the supply from incoming tourists. Consequently most of the people who supply the notes, usually called "money changers", obtain their supplies from England and the cost of these notes is calculated at slightly above the exchange rate plus the insurance and postage and thus if the exchange rate is equivalent to Rs. 13/7 per £, the notes will be sold at Rs. 13/8 per £. The international tourist agencies such as Messrs. Cook and Son and the American Express Co. Inc. are circulating out British currency notes during this season. They borrow each week a supply from London which they sell to

*outgoing tourists. The volume of this business is not, of course, very great when compared with the total trade of India ; but during the months of March, April, May and June when all the steamers go out fully occupied and even special steamers are run and people are prepared to pack up and embark at a day's notice, the demand for notes may exceed £5000/- per week, though in the busiest months for the returning people the surplus notes brought into India is comparatively insignificant.*

**Borrowing in London Temporarily** :—It may sometimes be impossible to employ any of these modes of remittance at a sufficiently cheap rate. The remitter, if he has suitable credit, can borrow money in London temporarily. This may be through overdraft arrangements with some bank or by drawing a bill on some bank or private person and discounting the bill after it has been accepted. But the remittance will have to be made at least when the bill becomes due. This method is usually available only to banks and the bill is called by the dignified name of "finance bill".

**Asking the Creditor to Draw** :—The creditor may also sell to some person or bank in England his right to money due in India. In this case he has the options that are available to the seller of London funds described below.

**Selling a Cable Transfer** :—When a person desires to sell his London claim he approaches a bank and asks it to receive payment in London against payment in India. If the seller is a bank, it can receive payment here first according to custom. If the seller is a private party, he will usually have to allow the bank to receive payment in London and get a cable to that effect before he will be paid in India. The cost of these cables is deducted from the rupee amount due to him ; but in the case of a bank, no such deduction is made, while, on the other hand, the buying bank has to pay the seller the cost of its cable to London ordering the payment of sterling.

**Selling a Sight or Demand Draft** :—He may find the cable costs too much or he may not have the funds ready in London but may expect them after about a fortnight. If he draws a sight draft and sells it to some one in India it may reach London when the amount was due. If the seller is foreign

payment will be made at once ; but a private person will have to wait till information is received that it has been paid. If the amount is large the news may be obtained by cable, the cost of which might be minimised by use of pre-arranged words. In other cases the news is conveyed by mail. The demand draft being a deferred payment in London, it will be bought for less rupees than the cable transfer.

**Selling a Usance Bill :—**The amount may be due after some months, in which case the bill will have to be a usance bill drawn payable on the date when the London funds will be ready. The seller will be treated as in the case of the demand draft unless it is connected with a trade movement and is accompanied by some documents giving the bank the security of the goods concerned. Even then payment will depend on the credit of the seller. In some cases the seller may be able to show the authority given to him by some bank in the form of a Letter of Credit promising to duly honour the bill. In this case the bill would be paid for on delivery.

**Selling through another Currency :—**It may be that the seller owes money to some one, in Java say, and he could send the bill on London to his Javanese creditor who could sell it to his bank there and it would send it to London and obtain payment. He may also find a bank that is willing to buy the bill on London not because it wanted to get London funds but because it could convert the funds into francs, marks, dollars etc. These operations are known as arbitrage and are explained in detail in a later chapter.

**Importing Gold or Silver :—**Gold and silver are always saleable in India in the bullion market and gold can also be sold to the Government at certain fixed rates which are not attractive at ordinary times. This method is subject to the limitations that go with exports of gold. The technique of the operations are explained elsewhere.

**Borrowing in London Temporarily :—**If it is not convenient to use any of the above methods, the seller could satisfy a bank of the genuineness of his claim in London and borrow from it on the strength of this security. He could

not, however, put off the sale of the sterling in order to liquidate his indebtedness to the bank.

**Importing Indian Currency :—**If Indian currency is available it could be sent to us in payment. During the war and just after it, several crores of rupees were issued by the Government of India for use in Iraq, Mesopotamia and Kenya. These were being gradually returned to us and used to settle the accounts due to us. Some idea of the size of these imports will be obtained from the following figures of arrivals of Indian currency into India during the last few years :—

Post-war average	1928-29	1929-30	1930-31	(in lakhs)
158	15	17	15	

This shows that most of the rupees have been returned. Indian currency is also being sent out every year to Aden by the Bombay Government at the rate of about 25 lakhs but these are not returned.

**Asking the Debtor to Remit :—**The debtor may also be asked to remit the money to India himself. He has the same choices of doing so as the remitter from India. This is, however, unusual as the supply of rupee exchange in London is very limited and it is far easier to sell sterling in India.

The methods described above as applying to India and London could be interpreted easily to apply to remittances between any other countries with some variations. So far as India is concerned rupee business in other centres is not done except in New York where the demand for rupees is due to the jute purchases for which that country desires to finance the movement itself. In other centres, the conditions obtaining between India and London obtain to nearly the same extent.

1. A bank buys D.D. at  $1/5\frac{1}{8}$  for £1000 and requests the London office to send out currency notes in exchange. Insurance and postage and other expenses amount to £2-0-0. Allow interest at 5% for 40 days between purchase of D.D. and sale of notes in India at Rs. 13-8-0 and find the profit on the transaction.

£1000 at $1/5\frac{1}{8}$	...	...	Rs.	13,379	12	9
Interest at 5% for 40 days	...	..		73	3	0
Expenses, £2-0-0	...	..		26	12	0
Cost of notes	...	..		13,479	11	9

Proceeds of sale at Rs. 13/8 ...	„	13,500	0	0
Profit on transaction ...	Rs.	20	4	3

2. A bank buys British currency notes at Rs. 13-6-0 for £2000 and sells D.D. against them at 1/5 $\frac{3}{4}$ . If the insurance and other expenses amount to £2-0-0 what is the profit on the transaction?

£2000 at Rs. 13-6-0 ...	Rs.	26,750	0	0
Insurance etc. ...	„	26	12	0
Cost of the notes ...	„	26,776	12	0
Proceeds of D.D. at 1/5 $\frac{3}{4}$ ...	„	26,806	4	6
Profit on transaction ...	„	29	8	6

## CHAPTER XIV.

### THE BILL OF EXCHANGE.

*“A bill as long as a pelican's”.*

The bill of exchange—Examples of bills—Demand and usance bills—Days of grace—Types of bills—Finance bills—Hundies—Stamp duty—Noting and protesting.

We have seen that the chief means of settling foreign claims is to do it through bills of exchange. When a man in India has a sterling amount due to him in London he can draw a bill of exchange on his debtor and sell it in India. Similarly if he owes money to a person in London, he can send him a bill on London issued by a bank. It is therefore necessary to have a clear knowledge of the bill of exchange.

A bill of exchange is defined as “an unconditional order in writing addressed by one person to another signed by the person giving it requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person or to bearer.” After inserting the commas and taking off the legal jargon, this means that it is a written order by the drawer on the drawee to pay to a third party or his order a given sum of money either on presentation or some time after it. When the drawee accepts the bill (if it is not payable at



sight) he becomes the acceptor and has acknowledged liability on the bill. The following are examples of bills of exchange :—

£200-0-0

Calcutta,  
30th June, 1931.

On demand pay the Chartered Bank of India, Australia and China the sum of Pounds Two Hundred only for value received.

Sd. Birla Bros.

Howard Smith, 3 East Street, London.

*Stamp.*

£2,000-0-0

Madras,  
20th August, 1930.

Sixty days after sight pay the National Bank of India or order the sum of Pounds Two Thousand Only, value received.

Sd. Ralli Bros.

To Ralli Bros., London.

*Stamp*

£725-7-3

Karachi,  
5th July, 1929.

On the 8th September 1929 pay the Eastern Bank or order the sum of Pounds Seven Hundred and Twenty-five seven shillings and three pence only, value received, being the price of seventy parcels of lizard skins sent by parcels post.

Sd. Latif & Co.

To Lazard Freres, Paris.

*Stamp.*

£750-0-0

Amritsar,  
10th May, 1931.

Three months after sight pay the Lloyds Bank Ltd., the sum of Pounds Seven Hundred and Fifty Only being the value of ten bales of carpets shipped per S. S. Elysia to Liverpool against L/C 3642 dated 10th April, 1931.

Sd. Frontier Carpet Co.

To The Midland Bank Ltd., London.

*Stamp*

£5000-0-0

Cawnpore,

15th April, 1931.

Documents against payment.

Ninety days after date pay to the order of the National City Bank of New York or order the sum of dollars five thousand only being value of copperware shipped to you per S. S. Caledonia on account of L/C No. 1784 of the Chase National Bank of the City of New York dated 10th March, 1931.

Brassware Manufacturing Co.

To John Wanamaker, New York.

*Stamp.*

£250-0-0

Berlin,

7th April, 1931.

Documents against acceptance.

Sixty days after sight pay the Netherlands Trading Society or order the sum of Pounds two hundred and fifty only value received, being the price of five cases of alarm clocks shipped to you.

Sd. Klientze and Bruder.

To Eastern Watch Co., Nagpur.

*Stamp.*

£2600-7-3

Birmingham,

17th June, 1931.

Documents against acceptance.

Sixty days after sight pay the Mercantile Bank of India the sum of Pounds two thousand six hundred shillings seven and pence three only, being the value of six cases of machinery parts shipped to you per S. S. Viceroy of India.

Sd. Tool Manufacturing Co.

To Messrs. Thornes &amp; Co., Rangoon.

*Stamp.*

Fcs. 25,000.00

Paris,  
25th May.Documents against payment only.

Ninety days after sight, second of exchange unpaid, pay the Comptoir National d'Escompte de Paris the sum of francs twenty-five thousand only, value received, being price of ten cases champagne shipped to you.

Port Wine &amp; Co.

Sorabji Daruwala &amp; Co., Bombay.

£300-0-0

Bombay,  
15th July, 1931.

On demand pay Mr. S. C. Biswambarnath the sum of Pounds three hundred only.

To

Sd. The Imperial Bank of Persia.

The Imperial Bank of Persia, London.

Bills of exchange are payable on demand or a certain number of days after date or after sight. Bills payable on demand are called demand or sight bills and other bills are called time or usance bills or just bills. In the second case the date of the bill becomes important to determine the date when payment is due and it is not necessary to present the bill to determine this date though it is usually the custom to present the bill if possible so as to secure the guarantee created by the acceptance. In the third case, presentation is necessary to decide the date of payment or maturity of the bill. The specified number of days begins to count from the date of presentation, whether the bill has been accepted or not. In England, Canada, India and most other countries the acceptor is allowed three days after the date of maturity thus calculated. These days are called days of grace but are now being exacted as a matter of right and not of grace. Thus a bill drawn payable 60 days after date (16th June) would be due not on the 15th August but on the 18th. In some continental countries

days of grace are not allowed and in some cases as in France all bills have three days grace whether payable on demand or not. In Canada all bills give the drawee the right of acceptance within two days after presentation and then the three days of grace or five days, even for demand drafts.\* This has to be taken into account by banks buying drafts and bills on Canada.

A bill of exchange is an inland bill if it is drawn in and payable in the country. All other bills will be foreign bills. Bills used for international commerce are generally foreign bills but we have seen that some bills drawn on other centres may be made payable in London if drawn in sterling. If a British exporter sends out such a bill on an importer in Europe he would probably return it payable in London thus making it an inland bill for the purpose of English law.

Bills of exchange may be classified as follows:—

1. Bills drawn by one bank on another
2. Bills drawn by an individual on another
3. Bills drawn by an individual on a bank
4. Bills drawn by a bank on an individual

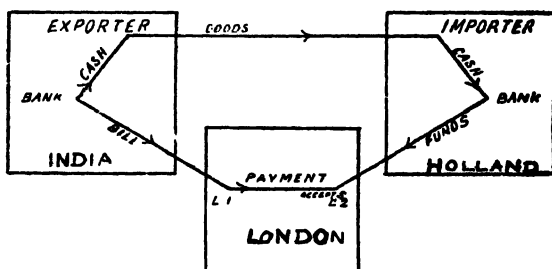
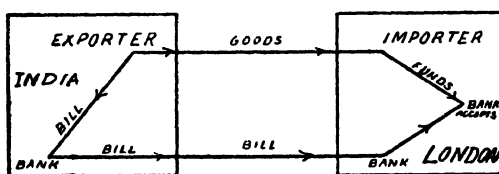
The first is known as the bankers' draft. The second is called a trade bill. The third is called a bank bill or bank acceptance. The fourth rarely arises as it would be beneath the dignity of a bank to draw on a private individual. It may, however, happen that a private individual is the only person on whom bills on certain places can be drawn but to this extent he must be looked upon as a banker.

When a bank wants funds in London it often arranges with a bank there to accept a bill drawn on it and discounts it in the market. But as the bill is for the purpose of helping the drawer bank, it is its business to provide the funds to meet it at maturity. Such an accommodation bill is in the case of banks called by the euphemistic name of "finance bill." The finance bill is used by banks when other means of remitting are not available or if they are too costly. Thus if a bank in Bombay

\* A somewhat similar custom prevails among the Nattukottai Chetties in Burma. Hundi-  
dies are verified on presentation and paid the next day.

has to provide ready money in London against sales and has either bought forward some months later or desires to postpone buying to a later date, it would use the finance bill to raise money temporarily in London for the period. So long as the bill is duly met at maturity, the discounter will never know whether the bill is for the account of the drawer or the acceptor. The drawee accepts such bills for a consideration which varies between  $\frac{1}{2}\%$  and  $1\frac{1}{2}\%$  per annum depending on the status of the drawer bank. There is a limit to such acceptances as the discount market will take only a certain volume of paper of any institution and if the limit is being exceeded, it would not, of course, refuse to discount it, but would raise the rate of discount which would damage the reputation of both the drawer and the drawee. The bills could be drawn by one branch of a bank on the London branch and it would still be taken by the market.

The London banks accept bills on behalf of almost every country and the following diagrams will illustrate how these bills come to be drawn and accepted:—



Diagrams 9 and 10. The London acceptance.

The bill of exchange as a means of transmitting funds from one place to another without sending actual money was known in India from ancient times. The instrument is known as the "Hundi" and may be a demand bill called the "Darshani Hundi" or a usance bill or "Muddati Hundi." It may be payable to bearer or it may be a "shahyog" or one which requires presentation through a "shah" or "shroff" or indigenous banker, or commercial bank. This instrument was apparently used in connection with foreign trade also but it would seem that it was only "darshani hundi" as the word hundi is used even to-day for the rate at which sterling can be remitted through demand drafts. In the bazar in Bombay the sterling rate is usually referred to thus and the practice also prevails for some other currencies.

The hundies have two essential differences from the bill of exchange. The first is that they are not simple orders to pay but are illuminated salutations with flowery greetings and ornamental invocations incidentally requesting the party addressed to pay the sum of money in question. For the purpose of negotiation this should not present any difficulty. But the second difference is more important. The hundi does not indicate the transaction from which it arose. Therefore, a person taking it does not know whether it is a banker's draft or a finance bill or a genuine trade bill or a genuine 'kite'. The first is quite acceptable if the parties are well-known. The third is most useful to discounters as they have the double assurance that the drawer, drawee and endorsers would see that the bill is paid at maturity and that there is some tangible security behind it. Indian business-men have adapted themselves to suit modern conditions and it is to be hoped that they will learn to come into line with the requirements of an organised money market by reducing the salutations to the minimum and by introducing an indication of the transaction giving rise to it.

These bills of exchange are evidences of claims payable in other places. It is the business of the exchange banks to buy them or collect them for holders and sell their own bills or

*cable transfers against them. Bills of exchange if not payable on demand are subject to the following duties in India :—*

*Table 12. Stamp Duty in India.*

Amount.			Sola		each of a set of 2		each of a set of 3	
			Rs.	As.	Rs.	As.	Rs.	As.
Less than	Rs.	200	0	3	0	2	0	1
Between Rs.	200	and 400	0	6	0	3	0	2
"	400	600	0	9	0	5	0	3
"	600	800	0	12	0	6	0	4
"	800	1,000	0	15	0	8	0	5
"	1,000	1,200	1	2	proportionately			
"	1,200	1,600	1	8				
"	1,600	2,500	2	4				
"	2,500	5,000	4	8				
"	5,000	7,500	6	12				
"	7,500	10,000	9	0				
"	10,000	15,000	13	8				
"	15,000	20,000	18	0				
"	20,000	25,000	22	8				
"	25,000	30,000	27	0				
Every additional	Rs.	10,000						
or part thereof		...	9	0				

In the case of a 90 days bill the stamp duty is equal to a tax of  $\frac{3}{4}\%$  per annum, for a 60 days bill to  $\frac{9}{16}\%$  and for a 30 days bill to  $\frac{1}{8}\%$ . In view of the heaviness of this tax the Central Banking Enquiry Committee has recommended the abolition of the duty, but this exemption need not extend to foreign bills as the purpose of the Committee's recommendation is to popularise the bill habit and these bills are already being drawn as usance bills.

Stamps must be affixed to export bills before they are presented to the bank. For import bills they must be affixed before presentation to the drawee. Some continental firms try to get over the duty by sending the documents without a bill but send their instructions in the form of letters. This is subject to the difficulty that in the case of bills for which documents are to be delivered against acceptance, there is nothing to accept and even if documents are to be handed over against payment, there is no instrument to fix the due date.

When bills are presented for acceptance, sometimes the acceptor makes it easy for the holder to receive payment by writing "Accepted payable at the———Bank." If the bill should pass through several hands, the final holder would find it easier to present it to the bank than at the drawee's address.

When a bill is not accepted or paid on the due date, it should be *noted* to that effect. In the case of bills on which non-British parties are liable, it is essential to extend it by protest in order to retain recourse against them. The noting is a simple matter and generally costs only about two or three rupees. But a protest costs ten to fifteen rupees in India because it has to be done by a notary public.

In several foreign countries noting is not available and it is necessary to protest a bill and difficulties sometimes arise through the foreign agents failing to protest. The law in some continental countries is that noting should be extended by protest within a certain time and the exchange banks in India must in such cases incur protest charges in order to preserve their rights against other parties. In some countries such as Brazil and the Central American countries even protests are not easy to register and transactions with these countries are not so popular as with others where legal help is available.\*

## CHAPTER XV

### THE READY RECKONER.

*"Fools may not enter here"*

Interest calculator—Sterling calculator—Lightning calculator—  
 Decimal conversions of sterling—And of rupees—Checking up  
 —Other matters.

It will be found that the calculation of interest for a specified number of days has to be done pretty often in exchange business. Seated in the comfortable surroundings of the counter or the desk all that one has to do for this purpose is to refer

\*A useful book to study in this connection is H. P. Sheldon's *Practice and Law of Banking*.



to the ready-made tables giving the answer in tens, hundreds and thousands of rupees for varying rates of interest for days from one to 365. Or one can call the assistant and ask him to do the thing. But if one is away from these surroundings he must know how to do it. At least his assistant must know it. For this reason the following shortened method of calculating interest given in Clare and Crump's "A. B. C. of Foreign Exchange" will be found useful.

If P be the principal, N the number of days, R the rate per annum the interest to be allowed is  $\frac{PNR}{100 \times 365} = \frac{2PNR}{73000}$ . The reduction of this involves division by 73 and a simple device for converting it into multiplication is based on the fact that  $73 \times 137 = 10001$ . Therefore  $\frac{2PNR}{73000} = \frac{2PNR \times 137}{1000 \times 10001} = \frac{2PNR \times 137}{100010}$ . But  $137 = 1 + \dot{3} + \dot{03} + \dot{003}$ . Hence we get the rule:—

Take the principal, multiply it by twice the rate and by the number of days. Add a third of it, then a tenth of it and then a tenth of that. Mark off five decimal places. The answer will be subject to an error of only 1 in 10,000. If we require only the first four digits, there is no error. If more accuracy is needed, deduct  $1/10000$  of the answer and the result will be correct to eight figures. As most interest calculations do not exceed four figures, the rule of third, tenth and tenth might be taken as giving the correct answer.

(1) Find the interest on Rs. 5,600 at 6% for 45 days.

5600	3024	amount
45	1008	third
	1008	tenth
28000	1008	tenth
22400		
<hr/>	414288	
252000	41	1/10000
12	<hr/>	
<hr/>	414247	
3024000		

The answer is Rs. 41'425 or Rs. 41-6-9.

It is always safe to estimate roughly the answer. Thus 6% of Rs. 5,600 is Rs. 336 and 45 days is roughly  $1/9$  of one year. The answer should therefore be about Rs. 40.

- (2) Find the interest on Rs. 16,743-8-0 at  $2\frac{1}{2}\%$  for 53 days.

$$16,743.5 \times 5 \times 53 = 44,370.275$$

443,703	amount
147,901	third
14,790	tenth
1,479	tenth
607,873	
61	1/10000

The answer is Rs. 60.781  
or Rs. 60-12-6.

607,812

As the answer is not required for more than six places, other figures are omitted.

- (3) Find the interest on £750-15-0 at 3% for 123 days.

$$750.75 \times 6 \times 123 = 554.053 \text{ nearly}$$

55,405
18,468
1,847
185

The answer is £7.590 or £7-11-10

75,905	n. wt.
--------	-----------

- (4) Find the interest on £7,234-7-3 at 2% for 37 days.

For our calculation we may take the principal as £7,234

$$7,234 \times 4 \times 37 = 1070.632$$

107,063	146,677
35,688	14
3,569	
357	146,663

The answer is £14.663 or £14-13-3.

146,677

- (5) Find the interest on \$3245.23 at  $2\frac{3}{4}\%$  for 143 days.

$3245.2 \times 5\frac{1}{2} \times 143 = 255234$  (other figures omitted)

25,523
8,508
851
85

The answer is \$34.97

34,967

The answer is about 35 dollars and is required for four figures and the working is taken only for five figures.

- (6) Find the interest on Yen 273232.23 at 4% for 153 days.

The answer is about 4,500 yen and the working need not be more than seven figures.

$2,732,322 \times 8 \times 153 = 3,344,362$	4,581,776
1,114,787	458
111,479	—
11,148	4,581,318
-----	The answer is therefore
4,581,776	Yen 4,581.32

The calculation of rates of sterling for D. D., bills, forward, etc. require some method for finding out one rate when another is known. The method usually adopted is to refer to a ready reckoner which gives the rupee equivalent of sterling and the sterling equivalent of rupees at various rates. Taking the value of £1,000 to start with, the rupee equivalent is made the basis of calculations as below :—

The T. T. rate is  $1/6$ , find the forward rate allowing for interest for three months in London at 2% lower than in India.

£1,000 at $1/6$ ...	Rs. 13,333 5 4
Interest at 2% for 3 months	66 10 8
	-----
	13,400 0 0
£1,000 at $1/5\frac{1}{4}$ is	13,379 12 9
£1,000 at $1/5\frac{3}{8}$ is	13,403 2 3

The desired rate is therefore  $1/5\frac{3}{8}$ .

But if the tables are not at hand, how vexing can the calculation of the rupee amounts at various rates be. The following method which may be called the **Lightning Calculator** would make the working much simpler and easily possible at all times :—

$1/6$  is 18d. or  $576/32d.$  or 576 units

Interest at 2% for 3 months is 2.88 units or 3 units.

The rate required should therefore be  $1/6 - \frac{3}{32} = 1/5\frac{3}{8}$

**How Simple and how Easy to get through !**

Then again take the calculation for a 90 days bill on London with discount rate at 3% and stamps at 1/- per £100 when T. T. is available at  $1/5\frac{1}{4}$ d.

£1,000 is the amount of the bill ...	£1,000
Less 93 days interest at 3% ...	£ 7.645
Less stamps at 1/- ...	£ .500
Net proceeds ...	£ 991.855

T.T. being available at  $1/5\frac{3}{4}$ , D.D.

should be available at  $1/6$ .

£991·855 at  $1/6$  is ... .. Rs. 13,225·333

£1,000 if bought at  $1/6\frac{1}{2}$  costs ... .. 13,218·589

£1,000 if bought at  $1/6\frac{1}{4}$  costs ... .. 13,241·379

Therefore the rate is  $1/6\frac{1}{2}$ .

The other method would work as below :—

$1/5\frac{3}{4}$  T.T. is the same as  $1/6$  D.D. = 576 points.

Interest on 576 for 93 days at 3% = 4·39 points.

Stamps at 1/- ... .. = 0·29 points .

The margin should be ... .. 4·68 or 5 points.

Therefore the rate should be 576+5 points or  $1/6\frac{1}{2}$ .

**How Simple again and how Easy at all times !**

It often becomes necessary to decimalise sterling sums for using them in calculations. Instead of the usual methods of multiplying or dividing, the following rules will be found useful :—

1. To convert shillings into decimal of a pound multiply by five and write it down with a decimal point before it. Multiply the pence by 4, add 1 to it if the number of pence is between 3 and 8 and add 2 if it is between 9 and 11. Then write zero before it, place a decimal point before it and add to the previous answer thus :—

$$£0\cdot17\cdot5 \quad .. \quad .. = £0\cdot85 + 0\cdot021 = £0\cdot871$$

$$£0\cdot13\cdot2 \quad .. \quad .. = £0\cdot65 + 0\cdot008 = £0\cdot658$$

$$£0\cdot19\cdot10 \quad .. \quad .. = £0\cdot95 + 0\cdot042 = £0\cdot992$$

To convert decimals into shillings the reverse process is followed thus :—

$$£0\cdot768 = £0\cdot75 + 0\cdot018 \quad £0\cdot15\cdot4$$

$$£0\cdot893 = £0\cdot85 + 0\cdot043 \quad £0\cdot17\cdot10$$

$$£0\cdot623 = £0\cdot60 + 0\cdot023 \quad £0\cdot12\cdot6$$

It is sometimes necessary to convert annas and pies into decimals of a rupee and *vice versa*. Here the following rule will be found useful. Take the first decimal place and convert into annas and pies by the following table :—

Decimal		as.	ps.	Decimal		as.	ps
0·1	...	...	1 7	0·5	...	...	8 0
0·2	...	...	3 2	0·6	...	...	9 7
0·3	...	...	4 10	0·7	...	...	11 2
0·4	...	...	6 5	0·8	...	...	12 10
				0·9	...	...	14 5

For the second decimal take two pies for every unit in the decimal subtracting one for 7, 8 and 9. For the third decimal take one pie if it is between 4 and 8 and two pies for 9, otherwise reject ; thus :—

$$\text{Rs. } \cdot 535 = 8\text{a.} + 6\text{p.} + 1\text{p.} = 8\text{a. } 7\text{p.}$$

$$\text{Rs. } \cdot 879 = 12\text{a. } 10\text{p.} + 1\text{a. } 1\text{p.} + 2\text{p.} = 14\text{a. } 1\text{p.}$$

$$\text{Rs. } \cdot 376 = 4\text{a. } 10\text{p.} + 1\text{a. } 1\text{p.} + 1\text{p.} = 6\text{a. } 0\text{p.}$$

$$\text{Rs. } \cdot 643 = 9\text{a. } 7\text{p.} + 8\text{p.} = 10\text{a. } 3\text{p.}$$

To convert annas and pies into decimals the tables can be used back again thus :—

8as.	3ps.	is	$\cdot 5 + \cdot 015$	...	...	$\cdot 515$
9as.	5ps.	is	$\cdot 5 + \cdot 09$	...	...	$\cdot 59$
14as.	8ps.	is	$\cdot 9 + \cdot 015$	...	...	$\cdot 915$
11as.	9ps.	is	$\cdot 7 + \cdot 035$	...	...	$\cdot 735$

A useful check on sterling calculations from rupees into pounds or pounds into rupees will be found useful. By a reference to the tables or by actual working in the case of a conscientious student of the subject, who thinks seeing is believing, it will be found that a difference in the rate of  $\frac{1}{32}$  d. for £10,000 is equal to Rs. 231 nearly and on Rs. 1,00,000 is £13, on Rs. 10,000 is £1-6-0 the rupee differences being respectively Rs. 173 and Rs. 17. Thus

$$\text{A difference of } \frac{3}{32} \text{ d. on } £4,000 = \frac{3 \times 231 \times 4}{10} = \text{Rs. } 277 \text{ roughly.}$$

$$\text{A difference of } \frac{1}{32} \text{ on } £6,200 = 6 \times 23 + 2 \times 2 \cdot 3 = \text{Rs. } 143.$$

$$\text{A difference of } \frac{1}{32} \text{ on } £2,350 \text{ is } 2 \times 23 + 3 \times 23 + \cdot 05 \times 23 \text{ or } 46 + 7 + 1 \text{ or Rs. } 54.$$

It will be found that in practice these answers are fairly accurate if the rate is about  $1/6$  and only by one or two rupees if the rate is  $1/5\frac{3}{4}$  or  $1/6\frac{3}{4}$ .

$$\text{A difference of } \frac{1}{32} \text{ on Rs. } 75,000 = \frac{3}{4} \times 173 \text{ Rs. or Rs. } 130 \text{ nearly.}$$

$$\text{A difference of } \frac{3}{32} \text{ on Rs. } 3,700 = 3 \times 3 \times 1 \cdot 73 + 7 \times 3 \times 1 \cdot 73 = 15 \cdot 6 + 3 \cdot 6 \text{ or Rs. } 19 \text{ nearly.}$$

The chain rule and contracted multiplication and division should be thoroughly understood by any one trying to deal in exchange ; otherwise he might make the same mistake as a man now great but who once made an experiment with the pendulum and calculated the value of gravity as 981'6349623 ! As most

answers in exchange calculations are only of five to six digits the products and quotients also must be worked out to the same limits and not more. The chain rule is of very constant use in these calculations and must be studied from some text-books. In the following pages a knowledge of this is assumed and the processes given also assume that the chain rule has been used to arrive at that stage of the work. It is not necessary to deal with these as they are given in any decent arithmetic text-book. It is important to emphasise once again the advisability of roughly estimating the answer before starting to work.

## SECTION II.

### CHAPTER XVI

#### T. T. AND D. D. BUSINESS.

*"I am t-t-t-t-to be d-d-d-d-dipped only twice."*

T.T. and D.D.—Margin between T.T. and D.D.—Factors affecting it—Air service.

The telegraphic transfer is a means of receiving foreign funds by cable or almost simultaneous payment in India and in the foreign country. This kind of business is fairly common for various reasons. A banker may often have to sell foreign currencies if he should require ready money in India. He may also be short in the foreign centre and have to buy exchange to make it up. The ordinary importer may have decided to take the exchange risk on his own shoulders so that when the time for payment comes he might ask for T. T. to effect it. A person may have sent goods on consignment and would like to bring the proceeds back as soon as possible. For several reasons there is thus a demand and supply of T. T. Most of this class of business in India is, however, between banks who have to shift their foreign balances one way or another.

The demand draft is a bill of exchange payable on demand or presentation to the drawee in the foreign centre. It arises in several ways. We have seen that people who have to make small payments would never use T. T. as the cost of cables would be prohibitive. They would purchase a D. D. and send it on. Missions and other bodies have authority to draw D. D. on their head offices to replenish their resources here whenever desired. Banks themselves may find it sometimes better to sell D. D. if they have to sell and their foreign balances are short. Sometimes with a high foreign balance they would prefer to buy D. D. instead of T. T. When small bills are retired it is found effectively cheaper to pay by D. D. and allow in the amount

interest for the transit period. Demand drafts come into India in fairly good amounts as remittances of Indians abroad or in payments of outstanding commissions or balances of consignment account. They are required for paying commissions to foreign agents, margins of bills, prices of samples and articles imported through the post and similar purposes.

If a bank sells T. T. the buyer always pays the seller the cost of its cable to order payment. In case of cables to London the cost is usually three words and in the case of New York it is four words except to ordinary customers who are charged the actual cost of the cable. The buyer has also to send his own cable to his agent to receive payment. The selling bank usually has a special set of code numbers registered with its various offices and thereby sends a message like the following in the three words allowed, two words being taken up in the address :—

AMEXCO LONDON

COSMOCOLON

meaning

Cable No. 172. Test number or word. Advise and pay the Mercantile Bank of India, London, the sum of pounds five thousand only.

These cables need not be signed as the place of origin indicates the authenticity of the cable, none but the Indian offices having access to the special number, etc. In the case of cables to other centres the charge is somewhat arbitrary.

The difference between the buying rates for T. T. and D. D. on London is  $\frac{1}{32}$ d. to compensate the buyer for the fact that the payment in London is about 15 days later than in India. According to the rule "the better the bill, the lower the rate" the rate for buying T. T. is lower than the rate for D. D. If the former is  $1/5 \frac{1}{32}$ , the latter would be  $1/5 \frac{1}{8}$  and if the former is  $1/6 \frac{1}{8}$  the latter would be  $1/6 \frac{5}{32}$ . This difference is equal to an interest charge of  $4 \frac{1}{8}\%$  which is just over the average loss of interest in London. Sometimes the London interest rate is higher but, as the next quoted sterling rate is  $\frac{1}{32}$ d. lower, which would be equal to a charge of  $8 \frac{1}{8}\%$ , it cannot be adopted. But a bank could refrain from buying D. D. at such times and thus, through lack of demand, force sellers to give up another  $\frac{1}{32}$ d. in the rate or to sell T. T. Similarly the standard differ-



ence between selling rates for T. T. and D. D. is  $\frac{1}{2}$ d. In some cases, as when the exchange rate is low or when the London rate is lower than 3%, the contrary state of things prevails and T. T. and D. D. are sold at the same rate but bought at  $\frac{1}{2}$ d. difference.

In the case of other currencies there is no established difference between T. T. and D. D. rates. It is generally higher than the difference in the sterling rates or equal to an interest charge of about 6%. Thus in the case of dollars the difference is 1 point, being 275 for D. D. against 276 for T. T. But the banks often give away  $\frac{1}{8}$ th or  $\frac{1}{4}$ th point in the rate which would make the difference the same as in sterling. In the case of francs it is nearly 3 points being 933 for D. D. against 930 for T. T. In the case of other currencies the differences are usually worked out from time to time.

In the case of a paper standard country or a silver one if the price of the foreign currency is fluctuating rapidly, the value attached to a D. D. or a payment later by about a month may involve an element of risk which will also be added to the rate. Thus, as we have seen, the T. T. rate on Shanghai when silver is  $12\frac{1}{2}$ d. in London and Bombay on London is  $1\frac{1}{5}\%$  is 89 rupees per 100 taels. Even allowing for one month interest at 12% the D. D. rate should be 88, but it would be actually quoted at 86.

With the operation of the air service the banks may find a new way to make profit in exchange. We have seen that the difference between T. T. and D. D. is due to the element of interest for the period of transit from India to London, New York etc. If the bills could be sent by air mail with a saving of 5 to 7 days, on large amounts this would be worth the trouble ; but as the air mail is not yet considered safe, it can only be used in cases where the bills have a complete set of duplicate documents which could be sent by mail steamer so as to make sure of at least normal transit period. In the case of a bill for £10,000 with interest at 3% in London, the saving for 5 days would be over £4-8-0 or Rs. 60/- nearly. Of course, this saving of interest will not be passed on to the customers of the bank

as the rates for T. T. and D. D. differ by  $\frac{1}{32}$ d. and this cannot be changed to a smaller margin.

Mr. S. E. Thomas\* believes that since the introduction of the air mail, cheques on India which are sent by air mail are charged for at  $\frac{1}{32}$ d. more than drafts which would be sent only through the ordinary sea route. This means that if rupees were being sold in London at  $1/5\frac{2}{32}$  for T. T., ordinary mail cheques would be sold at  $1/5\frac{7}{8}$  as the purchaser gets his rupees later than by T. T. and will pay less sterling for it. If the draft is to be remitted by air mail, the bank would try to charge the buyer  $1/5\frac{2}{32}$  which is  $\frac{1}{32}$ d. more than the ordinary cheque rate according to Mr. Thomas. This would mean that a person who wanted to send a draft by air mail would be charged the same rate as T. T. which can only be the case if he is willing to forego the interest for about ten days. Now if the amount was not large, he would not care to pay the higher rate for a few days saving in transit and if the amount was large it stands to reason that he would be business-like enough to pay for a cable remittance which would only mean a few shillings for the cost of the cable, instead of the loss of interest for ten days at 5% average or  $\frac{1}{4}\%$  which would amount to 25 sh. on a remittance of £1,000. We have seen that in the reverse direction, the bank takes the profit of the air mail service to itself and does not pass it on to clients. In fact it is found that it sells T. T. and D. D. now (July 1931) at the same rate but buys D. D. at  $\frac{1}{32}$  higher than for T. T. though it could easily send the drafts by air mail which the ordinary buyer would not.

1. The T.T. selling rate being  $1/5\frac{3}{32}$  a bank buys T.T. £10,000 at  $1/6$  and sells it, what is the profit after paying brokerage  $\frac{1}{2}\%$  and cable charges Rs. 6-0-0?

£10,000 at $1/5\frac{3}{32}$	...	...	Rs. 1,33,565 3 6
Less brokerage	Rs. 41 11 40		
Cost of cables	„ 6 0 0	Rs.	47 11 10
<hr/>			
Amount realised	...	Rs.	1,33,517 7 8
Cost of £10,000 at $1/6$	...	„	1,33,333 5 4
<hr/>			
Profit	...	Rs.	184

\* Principles and Arithmetic of the Foreign Exchange.

2. A bank buys D.D. at  $1/5\frac{3}{4}$  and sells T.T. at  $1/5\frac{1}{4}$  for £5,000. If its London funds cost 2% what is the profit (Brokerage  $\frac{1}{16}\%$ )?

£5,000 at $1/5\frac{3}{4}$ ...	...	Rs. 66,782 9 9
Interest at 2% for 15 days	...	„ 54 14 3
		<hr/>
Cost of £5,000 and interest		Rs. 66,837 8 0
Proceeds of £5,000 at $1/5\frac{1}{4}$		„ 67,132 13 10
Less brokerage at $\frac{1}{16}\%$ ...		„ 41 15 4
		<hr/>
Net Proceeds of sale	...	Rs. 67,090 14 6
Profit	...	„ 253 6 6

3. A bank buys T.T. at  $1/5\frac{3}{4}$  for £3,000 and sells D.D. at  $1/5\frac{1}{4}$  and pays brokerage at  $\frac{1}{32}\%$ . If it receives interest in London at 2% and pays cable charges Rs. 4-8-0 what is the profit?

£3,000 at $1/5\frac{3}{4}$ ...	...	Rs. 40,069 9 9
Plus cost of cables	...	„ 4 8 0
		<hr/>
Equivalent at $1/5\frac{1}{4}$		Rs. 40,074 1 0
Less brokerage at $\frac{1}{32}\%$		„ 40,139 6 0
		<hr/>
Less interest at 2% for 15 days		Rs. 40,126 13 4
		„ 32 15 0
		<hr/>
Profit		Rs. 40,093 14 4
		„ 19 13 4

4. A bank buys D.D. at  $1/5\frac{3}{4}$  for £7,000 and sells at  $1/5\frac{2}{4}$  and pays brokerage at  $\frac{1}{16}\%$  what is the profit?

£7,000 at $1/5\frac{3}{4}$ ...	...	Rs. 93,495 10 4
£7,000 at $1/5\frac{2}{4}$ ...	...	„ 93,821 15 8
Less brokerage $\frac{1}{16}\%$ ...	...	„ 58 10 3
		<hr/>
Profit		Rs. 93,763 5 5
		„ 267 11 1

5. A bank buys £5,000 D.D. at  $1/5\frac{3}{4}$  and sells T.T. 15 days later at  $1/5\frac{2}{4}$  paying brokerage at  $\frac{1}{32}\%$ . What is the profit allowing interest in India at 5%?

£5,000 at $1/5\frac{3}{4}$ ...	...	Rs. 66,782 9 9
Plus interest for 15 days at 5%		„ 137 3 9
		<hr/>
Cost of £5,000 ...		Rs. 66,919 13 6
£5,000 at $1/5\frac{2}{4}$ ...		„ 67,015 11 2
Less brokerage at $\frac{1}{32}\%$		„ 20 15 1
		<hr/>
Net proceeds	...	Rs. 66,994 12 1
Profit	...	„ 74 14 7

6. What is the sterling equivalent of Rs. 23,435-10-0 for a D.D. when the T.T. rate is  $1/6$ ?

T.T. being  $1/6$  D.D. is  $1/6\frac{1}{32}$ .

At $1/6\frac{1}{32}$	...	Rs. 20,000	=	£ 1,502.604
"	...	" 3,000	=	£ 225.390
"	...	" 400	=	£ 30.052
"	...	" 30	=	£ 2.254
"	...	" 5	=	£ 0.376
"	...	" 10	=	£ 0.047
				£ 1,760.723 = £ 1,760-14-5

7. A bank sells a D.D. for £12,000 at  $1/6\frac{1}{32}$  and remits a D.D. at  $1/6\frac{1}{8}$  by air mail. What is the profit it makes if interest in London is received for 7 days at 2%?

£12,000 at $1/6\frac{1}{32}$	...	Rs. 1,59,722 11 2
£12,000 at $1/6\frac{1}{8}$	...	" 1,59,446 5 10
Less interest for 7 days	...	" 61 10 1
		Rs. 1,59,384 11 9
Profit	...	" 337 15 5

8. A bank sells D.D. for £7,500 at  $1/6\frac{1}{32}$  and buys T.T. at  $1/6\frac{1}{8}$ . If the draft is sent by air mail in ten days what is the profit (London interest 2%, brokerage  $\frac{1}{8}$  %)?

£7,500 at $1/6\frac{1}{32}$	...	Rs. 99,826 11 0
Less brokerage		62 6 3
		Rs. 99,764 4 9
£7,500 at $1/6\frac{1}{8}$	...	Rs. 99,653 15 8
Less interest at 2%		
for 10 days	...	" 54 9 7
		Rs. 99,599 6 1
Profit		Rs. 164 14 8

9. A bank sells T.T. for \$23,000.00 at 274½ and buys D.D. at 272½. Find the profit it makes allowing for interest in New York for 25 days at 4%.

\$23,000.00 at 274½	..	Rs. 63,135 0 0
\$23,000.00 at 272½	..	Rs. 62,732 8 0
Interest on this amount at 4%		
for 25 days	..	Rs. 171 14 0
The cost of \$23,000.00 bought is		Rs. 62,904 6 0
Profit on transaction	..	Rs. 230 10 0

10. A bank sells T.T. for Francs 785,000.00 at 933 and buys them at D.D. at 940. Allowing for interest in Paris for 15 days at 2½% ascertain the profit on the transaction.

Francs 785,000.00 at 933	.. =	Rs. 84,137 3 3
Francs 785,000.00 at 940	.. =	Rs. 83,510 10 3
Interest on Fcs. 785,000.00 at 2½%		
for 15 days is Fcs. 806.59 or	=	Rs. 86 7 0
Cost of Fcs. 785,000 bought is	=	Rs. 83,597 1 3
Profit on the transaction is	.. =	Rs. 540 2 0

11. A bank buys D.D. for Yen 78,000·00 at 136½ and sells T.T. against it at 138. Ascertain the profit it makes allowing for interest charge in Japan at 5½% for 25 days.

Yen 78,000·00 at 138 .. ..	Rs. 1,07,640 0 0
Yen 78,000·00 at 136½ .. ..	Rs. 1,06,470 0 0
Interest on Rs. 106,470 at 5½% for 25 days .. ..	Rs. 401 4 0
Cost of Yen 78,000·00 bought is	Rs. 1,06,871 4 0
Profit on transaction .. ..	Rs. 768 12 0

## CHAPTER XVII.

### THE LONG EXCHANGE.

*"For he was long and lank and lean"*

What is long exchange—The bill rate—Long bill basis of exchange—Profit of exchange banks.

The true basis of the rate of exchange between two countries is the proportion between the supply of bills and the demand for remittance. So far as the supply of bills is concerned the most important is the trade influence which shows itself through exports. Now when a person sends goods to a person in another country, he cannot expect to receive payment before the other person is able to obtain control of the goods. The bill of lading, insurance policy and invoices are the documents which give such control and while the foreign importer may employ an agent in India to make payment, or the Indian exporter may have arrangements with his bank to pay him ready money for these documents, the basis of the sale of the goods is that payment will be made some time, usually three months, after the goods reach the hands of the importer. It may be said that the exporter would not part with the goods without having some tangible proof of his claim for payment and this claim is made in the form of a bill of exchange drawn on the importer which the latter accepts as token of his promise to pay. It is this bill, therefore, that is the basis of the supply of exchange. The rate at which banks can afford to buy such bills is the rate at which exchange will be quoted. If the supply begins to give way, the demand cannot be met through the purchase of bills but will have to be met by other methods,

and the cost of supplying the demand from other sources will vary with the circumstances.

When an exchange banker pays for an export bill, he has the documents in his hands until the time of the acceptance of the bill by the drawee, and when it is accepted, he has usually to hand over the documents to him. The banker's only hold is the security of the various parties to the bill as evidenced by their signatures on it. The drawer, the drawee and any intermediate endorser are all liable, but there is the possibility, remote it may be, of the drawee failing between the time of acceptance and the due date of payment of the bill. The banker will, therefore, have to allow for this chance and the expenses incidental to such a failure. Sometimes the banker is unwilling to undertake this risk either on account of his lack of faith in the drawer of the bill or on account of his lack of faith in the drawee. In either case, he will not buy the bill, but take it for collection and pay the proceeds after realisation. This gives rise, therefore, only to a payment in India on the due date of the bill, but the exporter may be able to fix the exchange rate in advance as this does not involve the same risk as in the case of the bank's purchase of the bill itself. So far as the effect on exchange rates goes, it is the same as if the bill had been sold for ready cash, because the bank buying the proceeds for the forward delivery, would normally sell ready against it.

To understand how the rate of purchase for bills is worked out, we must take into account the fact that payment in India is made several weeks before payment is made by the drawee. There is the interest for the transit period of the bill, which is usually charged at the Imperial Bank of India rate, because the bank is out of funds in India. Then there is the discount in London for the tenor of the bill and this will be at the London market rate for first class bills, and at rates varying with the standing of the parties in the case of other bills. Then there are bill stamps in London which are levied on all bills not payable at sight, on an *ad valorem* basis as in India. Then there are bank's commission charges in London. In practice, these charges are not made if a good deal of business passes both ways. Lastly, there is the trade risk of the parties to the

bill failing in the interval. This is different from the higher interest rate charged in London on these bills which is due to the fact that the banks may have to keep the bills in their portfolio or have to discount in the market at a higher rate. Thus the difference between the T. T. rate and bill rate will consist of the following elements :—

1. Interest for transit period.
2. Interest in the foreign centre for the usance.
3. Stamp charges.
4. Commissions etc.
5. Trade risk.

These are represented diagrammatically below :—

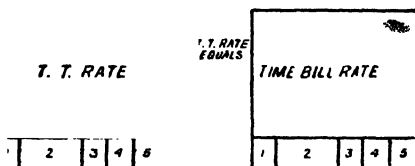


Diagram 11. Bill rate for moveable exchanges.

Diagram 12. Bill rate for fixed exchanges.

The relative importance of these factors in determining the purchase rate of bills is thus explained by Lord Goschen in his "Theory of Foreign Exchanges" :—

"There is no element of value so constant and effective as the rate of interest of the country on which the bill is drawn. The fluctuations in sight bills are limited, to a certain extent, by what we have called the specie points; they can exceed the specie limit either upwards or downwards for a time only. But the fluctuations in long bills on the other hand are unlimited because they are co-extensive with the fluctuations in the value of money in the accepting country and co-extensive too with the apprehensions which may be felt as to the solvency of the name on the bills."

It is curious that in India local stamps on the export bills are affixed by the exporter and foreign stamps are deducted from the amount paid to him by being included in the rate of exchange. In the case of import bills, however, the foreign bill stamps are included for collection from the Indian importer who has also to pay local stamp charges. The custom in other countries is for local stamps to be included in the amount of

the bill and foreign stamps to be paid by the exporter. Perhaps the exchange banks have not till now noticed this difference.

So long as the factors affecting long exchange do not vary, the spread between the T. T. and D. D. rates or spot rates as they are called and the bill rate or long rate is constant and when one of them moves the other will also move. Thus if the spot rate is  $1/5\frac{3}{4}$  and the long rate is  $1/6\frac{1}{8}$  and if the former changes to  $1/5\frac{1}{2}$  for some reason, the latter will also drop to  $1/6\frac{1}{4}$ . If the latter changes to  $1/6\frac{3}{4}$  for some reason, the former will follow up to  $1/6$ . If they do not, someone will buy at the cheaper rate and sell at the dearer rate and the transaction will adjust the rate lowering one rate and raising the other.

Just as we can find the bill rate when we know the sight rate or the T. T. rate, we can find the sight or T. T. rate when we know the bill rate. Thus, when a ready or forward purchase of bills is made the seller usually demands a certain rate and the bank will have to work backward and find the rate at which T. T. will have to be sold for delivery when proceeds are due in London, if it is to make a profit on the transaction. In the case of sterling and other moveable exchanges, the interest and stamp charges and the trade risk will have to be deducted from the bill rate and smoothed off to allow a margin also for the brokerage it will have to pay. In the case of the fixed exchanges they will have to be added to the bill rate and smoothed off to allow the margin.

It is not always possible to set off the supply of export bills against the demand caused by the import bills. Some of the bills might appear at a time when the banker does not know whether he will be able to secure demand from his own clients. Similarly the demand might arise at a time when the banker has no supply on his hands. It is ordinary business prudence that, as far as possible, the banker should maintain a clean slate at the end of each day's business. Otherwise, the rate of exchange might move overnight owing to various reasons and he might find himself involved in a



loss which might be greater than any gain he might have anticipated by trying to depend on his clients for clearing his position.

The rate at which the bank will sell exchange against bills depends on two factors. The first is whether the total business turned over is large in comparison with the amount to be thus "covered" and the second is the presence or absence of keenness in the market to buy when it wants to sell. In general, the bank meets from its own clients one third of the supply of bills and the other two-thirds, it has to sell. This means that, of the total demand on the bank for foreign currency, it is able to meet one-third of it from supplies of bills coming to its hands at the same time and it has to buy the rest in the open market. Consequently, of the 300 odd crores of exports which give rise to about 250 crores of bills passing through the banks, about 85 crores are directly offset by the banks through their own clients. The other 165 crores are resold. Similarly, of the total of 200 crores of imports which pass through the hands of the banks about 85 crores are directly set off against bills and the balance of about 115 crores is purchased in the open market.

The Government remittance demand of approximately 50 crores is for ready T. T. while, in the case of T. T. sales to other parties, the banks try to sell the exchange for delivery at the time when the proceeds of the bills would be realised. when the Government calls for tenders for sterling, they usually do it at a time when bills are plentiful and the banks being all sellers are glad to avail themselves of the opportunity to sell good amounts. The Government can depend on obtaining the middle rate like the banks. Thus the whole of the 165 crores resold would be put through at the intermediate rate. The banks which purchase the 115 crores of resales, sell them to their own clients. The banks, between them all, thus make a profit of  $\frac{1}{16}$ d. on 85 crores and  $\frac{1}{32}$ d. on 50 crores and both the selling and the buying bank make each  $\frac{1}{32}$ d. on the other 115 crores. On this latter amount, the banks which buy the original bills and which appear as sellers on the market have to pay brokerage as also  $\frac{1}{16}$ % on the 85 crores

sold to their clients. Normally, therefore, the total profit on the exchange side of the transaction is as follows:—

1/16d. on 85 crores	1,700/32	million pence	
1/32d. on 50 crores	500/32		"
1/16d. on 115 crores	2,300/32		"
Total ...	4,500/32		"
or equivalent of ...	...		Rs. 78 lakhs.
Less brokerage on 115 crores at 1/32%			" 4 "
" " " 85 " 1/16%			" 5 "
This gives a profit of ...	...		" 69 lakhs.

There is in addition the profit on the purchases and sales of exchange by the big commercial firms like Volkarts and Ralli Bros. on which, at a conservative estimate, the banks should make a profit of 6 lakhs of rupees on a turnover of about 50 crores. We have seen in another chapter that the profit of financing internal trade is about 90 lakhs. The total is thus about 165 lakhs and after allowing for expenses, bad debts etc. there is a net profit of more than one crore rupees per annum, which they share among all of them. This does not take into account miscellaneous profits such as commissions on opening credits or marginal profits on purchase of bills or commission charges on inward bills.

It is not possible therefore for one to agree with the foreign experts of the Central Banking Enquiry Committee when they say that the profits of the exchange banks are a compensation for the London funds which they bring into India to finance her trade. From the figures quoted in Chapter I it will be seen that, so far as the British banks are concerned, they do not, on balance, use any of their money to finance India's foreign trade. They may use them for buying import bills in London but this is *their* half of the business as we have shown in Chapter III. Of course, the efficiency with which they do the work of financing foreign trade and the absence of any Indian banks to take up any part of the work makes it necessary for us to pay them a service charge which we cannot avoid.

1. If the rate required for a 90 days D/A bill is  $1/6\frac{7}{8}$  find the rate at which the bank should sell T.T. for delivery when the funds will be ready in London, market rate being 5%.

$1/6\frac{7}{8} = 590$  units.

Interest on this for 93 days at 5%	..	=	7.42	units.
Bill stamps	.. .. .	=	0.29	„
Brokerage at $\frac{1}{8}\%$	.. .. .	=	0.19	„

7.90 or 8 units.

The equivalent sight rate is  $1/6\frac{7}{8} - \frac{3}{8} = 1/6\frac{3}{8}$  and T.T. rate is  $1/6\frac{3}{8}$

The selling rate should be  $\frac{1}{8}$  better or  $1/6\frac{1}{8}$ .

2. If London Bank rate is 3% and the holder of a commercial 90 days D/A bill wants  $1/6\frac{1}{2}$  what is the rate at which T.T. may be sold against the proceeds to make a profit?

$1/6\frac{1}{2} = 577$  units

Interest on this at 3% for 93 days	..	=	4.41	units.
Stamps	.. .. .	=	0.29	„
Brokerage	.. .. .	=	0.19	„

4.89 or 5 units.

The corresponding sight rate is  $1/6\frac{1}{2} - \frac{5}{8} = 1/5\frac{1}{8}$  and the T.T. rate is  $1/5\frac{3}{8}$ . The selling rate should therefore be  $1/5\frac{1}{8}$ .

3. A seller of a dollar 60 days D/A bill wants 272 for it. What is the rate at which T.T. should be sold against it, the New York rate is 4%?

Interest on 272 for 63 days at 4%	..	=	1.87	points.
Brokerage at $\frac{1}{8}\%$	.. .. .	=	0.17	„

2.04 points.

The equivalent D.D. rate is  $274\frac{1}{2}$ .

The T.T. rate is  $275\frac{1}{2}$  and the selling rate would be 277.

N.B. Bill stamps are not charged in the United States.

4. A bill on Paris has to be bought at 940. Find the rate of selling D.D. against it if Paris Bank rate is 4%.

Interest on 940 at 4% for 2 months	..	=	6.27
Stamps at $\frac{1}{20}\%$	.. .. .	=	0.47

6.74 or 7. points.

The D.D. rate is 933 for buying.

The D.D. rate for selling should therefore be 930.

5. A bank buys a 60 days D/P bill at  $1/6\frac{5}{8}$ . London bank rate being  $5\frac{1}{2}\%$  and bank rate in India  $7\%$ , find the T.T. selling rate which the bank would have to get.

Interest on $1/6\frac{5}{8}$ or 581 points for	
63 days at $5\frac{1}{2}\%$ .. ..	= 5.51
Interest on 581 points for 15 days at $7\%$ .. ..	= 1.69
Stamp charges .. ..	= 0.29

7.49 or 8 points.

The difference is 8 points and the equivalent T.T. rate is  $1/6\frac{5}{8} - \frac{8}{32} = 1/5\frac{29}{32}$ . The selling rate is therefore  $1/5\frac{7}{8}$ .

## CHAPTER XVIII.

### FORWARD EXCHANGE.

*"To buy or not to buy, to sell or not to sell."*

The exchange risk—The exchange contract—How forward business originates—Distributing supply of exchange—Forward market—Premium and discount—Factors affecting forward rate—Relation between ready and forward rates—Forward rupees elsewhere.

When a merchant buys produce with the hope that he can sell it at a profit at a future date, he does so on one of two assumptions. The first is that as he has bought wholesale he has obtained a good rate and could sell it at a higher price in retail which would cover his expenses and give him a profit. The second is that he has bought at a time when the price was very low and that it would rise again allowing him to sell at a profit even wholesale. This is pure speculation because the price might as well go just a little lower as higher. There are certain cases in which this anticipation is justified. Thus in an agricultural country the prices ruling soon after the harvest are always lower than those a few months later. However, prudent merchants would not take such a risk but would rather "*pass it on*" to others, if possible, who are engaged in the business of taking these risks.

This desire to pass it on would be found in all people dealing with commodities. When a man buys goods from a foreign country, he has to deal not only with the chance of

prices varying in his own country but of the value of his home currency changing in the meantime with reference to that of the country from which he is importing. This is known as the exchange risk. The cautious merchant tries to pass on this risk to others by arranging to make a contract for an agreed future date, and it would be the business of those others to burden the risk. In the same manner an exporter who has booked an order to sell goods may have accepted a quotation in foreign currency and, as he keeps his accounts in local currency and must ascertain his profits in that currency, he must make sure that his profits will not be reduced by variations in the exchange rate. It is to his interest to pass on the exchange risk to others and leave it to them to tide over it. The exchange bank specialises in this business of taking over the risk from both the classes of people.

When a person thus enters into a contract with a bank, he does not pay for the purchase at once nor does he receive payment. In the same way no foreign currency or claims to it are handed over. It is only an arrangement that, on the agreed date, the buyer would pay here for the foreign currency to be delivered over to him or his agent abroad. We have seen that the broker is an indispensable part of these transactions and his deposit with the banks is a guarantee to them that he would not bring proposals from unreliable parties and that they can, therefore, expect that the contracts would be duly fulfilled. The contracts are usually made for a certain month, for a fortnight or for a week or even for two months. In the case of T. T. the option of choosing the date is with the buyer and in the case of bills the option is naturally with the seller. The buyer may choose to take up his contract a little too early or too late within the period agreed, and the seller also may deliver the bills too early or too late. The bank may then be put in an awkward position by being short of rupees or short of foreign balances.

To the extent to which the bank has the supply and demand for forward exchange, it would "match" one against the other and be satisfied with a small margin of profit. But it does not always happen to be so. The demand may be for

July funds and the supply may be of September funds. It may decide that it can adjust its resources so as to suit the case or it might keep the position in mind and wait for a chance to buy the July funds which it has sold and sell the September funds which it has bought.

Forward exchange dealings are created in other centres through financial operations. A higher interest rate would draw foreign funds which would be anxious to obtain the benefit of the higher rate. This would, of course, refer not to the long term rate applying to Bonds and Loans but to the short term money rate. Supposing it was possible for an investor to obtain 5% for his money in India if it is invested for at least three months, and that, in another country he could get only 2%, he would be eager to bring in the money to India. But as he must be sure that he would not lose the interest earnings in the exchange rate when he wanted to take away his money back, he would "hedge" himself by a contract to sell back the rupees.

As an agricultural country we sell most of our goods soon after the harvest but our imports come in fairly steadily all the time as they are manufactured goods. Consequently, the supply of exchange is heavy in some months and the exporters have to be content with fewer rupees or wait for a possible change later on if demand should develop. But this is uncertain and so some exporters get over this by selling the bills in July to September for delivery in the busy season and obtain a somewhat better rate than in December or January.

The rate at which the bank will buy or sell forward exchange in India varies chiefly with the time of the year. In view of the seasonal variation of the supply and demand, the bank would try to base its rate on the probable rate at the time for which the contract is to be made. Thus, when the rate in December is  $1/6\frac{1}{2}$ , a forward contract for the following April may be quoted at  $1/6$  and in the month of July when the rate is  $1/5\frac{1}{2}$  a forward contract for November may be quoted at  $1/6\frac{1}{2}$ . In other words the forward rate is definitely linked with trade possibilities.

But the bank cannot ignore the question of interest which

is the dominating factor elsewhere. Thus, if it would not be prepared to keep an open position, it should buy sterling for approximately the same date as it has sold. As this may not be possible, it may have to buy ready sterling leaving it waiting for some months before paying it out when the contract matures. During this period it is out of money in India which might have earned it interest at 4% while the foreign interest might be only 2%. In the reverse case when funds in India are cheaper the seller of ready might be charged 4% abroad while it would get only 2% in India. If it is overdrawn abroad, it might find it worth while to buy ready sterling and be even prepared to pay a difference in the rate to do so.

The sale of export bills in India which totals about 250 crores per annum is concentrated in a few months and the imports are spread over the whole year. Hence if the export bills are bought in the busy season without any corresponding demand arising for them, the chances are that the exchange rate might rise to a high level during the busy season and fall down very low in the slack season. We should not then be surprised if the rate were  $1/6\frac{3}{4}$  in December and  $1/5\frac{1}{4}$  in July. No doubt the exchange authority in India should prevent such wide fluctuations, but even with the limits of  $1/5\frac{9}{16}$  and  $1/6\frac{3}{4}$  the margin is very wide. By intelligent anticipation some future purchasers might contract for their purchases during the selling season and some future bill sellers might also sell their bills in the slack season. The exchange bank by acting the part of the speculator in minimising these variations acts as a benevolent bull or a beneficent bear and the usual fluctuation is limited to within  $\frac{3}{8}$  to  $\frac{5}{8}$  of a penny.

The bank could cover a forward sale in one of four methods:—(1) buying ready, (2) buying forward for the same delivery or near thereto (3) buying a bill maturing about that date, (4) leaving the position open. Similarly, to cover a forward purchase it has three options:—(1) selling ready, (2) selling forward for the same or approximate delivery, (3) leaving the position open. The choice of the actual method depends on various considerations. If the bank has sold and has a low foreign balance, we have seen that it would buy ready. If it

has a large foreign balance earning low interest, it would sell ready against a forward purchase. If it feels quite certain of bills showing later on owing to good crops, it would leave an open oversold position. But if the crop forecasts are not hopeful, it might not do so. If the demand for remittance is expected to develop later on, it would keep an open overbought position, otherwise it would liquidate it at once. The sale or purchase for the same or approximate delivery is the best but this is not at its choice. The brokers would, of course, try their best to get in touch with clients who wanted to do so and, if any are found, the bargains would be concluded.

"The chief conditions requisite for a properly functioning forward market are (a) the easy transferability of funds from one country to another which itself postulates an active prompt exchange market, (b) a difference in interest rates ruling in the two centres *i.e.* a higher rate of interest in one centre than in another and (c) an active and well-organised foreign trade. Safety and confidence are no less important factors."\*

All these factors are found in India and the forward market in sterling is therefore an active and brisk one. In fact, it is so well organised that one can make contracts up to six months forward without any difficulty and even nine months in special circumstances. Banks are not anxious to make commitments of longer duration. Exporters and importers who have to deal in sterling for their trade are thus able to convert them into rupees and the effect is the same as if we drew in rupees and we had rupee bills drawn on us. The forward business is, however, confined to sterling, as we have seen that the other currencies are not really active even in the ready business. If a person insists on forward dollars, for example, he would be quoted a rate that would probably make him content to take the risk of the exchange.

In other centres the chief factor in deciding the difference between ready and forward rates is the interest difference between the two centres. Thus, if a bank buys four months forward T. T. on London with an interest difference of 2% higher in London, the difference or spread between the rates

\* W. F. Spalding, —Banking and International Exchange—Modern Business Institute Series.



will be  $\frac{2}{3}\%$  of the rate. This will be added to the ready rate if it is moveable and deducted if it is fixed. Similarly, if the London rate be lower by 2%, the difference of  $\frac{2}{3}\%$  will be deducted from the moveable rates and added on to the fixed rates. The interest rates in question are not the bank rates but the value of funds for the terms of the contract, three, four or six months as the case may be. If a bank was buying three months forward instead of ready it would lose the interest abroad on three months funds and gain the local interest on three months funds. Hence we get the following rule:—

For the *Fixed Exchanges*—

Forward rate plus		Ready rate plus
Foreign interest plus	=	Local interest plus
Trade tendencies		Trade tendencies

And for the *Moveable Exchanges*—

Forward rate plus		Ready rate plus
Local interest plus	=	Foreign interest plus
Trade tendencies		Trade tendencies.

When the forward rate is higher than ready, it is said to be at a “premium” and when it is lower, it is said to be at a “discount”; and when the rates are the same, they are said to be “even”. They are also said to be “against you” as a buyer when forward costs more local currency than ready and to be “in your favour” when it costs less local currency than ready. As a seller the reverse would be the case, “against you” if forward gives less local currency and “in your favour” if it gives more. The description in this case would therefore be different for the moveable and the fixed exchanges.

The following examples will show how the interest rates affect the forward rates. We assume in the first two that London three months rate is higher than Bombay by 2% and in the other two that it is lower by the same difference. The rate for ready is assumed to be  $1/6\frac{1}{8}$  in all four cases. In two of them the bank buys forward and sells in the other two.

(1) If ready is bought against a forward sale, the bank will gain 2% in London for three months or  $\frac{1}{2}\%$  which is  $\frac{1}{2}$  of 5.78 units or 2.89 units. It could therefore afford to give  $\frac{2}{3}d.$  in the rate and make a profit. The forward rate

would therefore be  $1/6\frac{1}{18}$  plus  $\frac{1}{18}$  or  $1/6\frac{1}{6}$ . (2) If ready is sold against a forward purchase, the bank will lose 2.89 points in interest and it would quote 3 points higher for buying forward or the rate would be  $1/6\frac{1}{18}$  plus  $\frac{3}{32}$  or  $1/6\frac{5}{32}$ . (3) If ready is bought against a forward sale, the bank will lose 2.89 points and would charge it to the forward buyer and the rate would be 578—3 points or 575 points, that is,  $1/5\frac{31}{32}$ . (4) The seller of ready would gain 2.89 points and he would be prepared to buy forward at 578—2 or 576 points or  $1/6$ .

In actual practice the bank would not give away the profit of interest differences but some competing bank would offer to do the business at a difference of one point and some one else would offer to do it at 2 points, as there is still some profit to be made. Thus the market rate would tend to the economic rate. Beyond this there could not be competition in the ordinary course, as the next rate would mean 3 points which would bring an actual loss.

It sometimes happens, however, that the bank is paying overdraft interest in London at bank rate and the London funds might be worth more to it than the market rate and it would be prepared to do the business at three points difference. But as there would be no competition from other banks in this respect, this would not be a normal feature. Similarly, a bank overdrawn in India might be prepared to give away three points instead of the usual two but this also would be exceptional. It also happens that sometimes the buyer might be unable to lend in other centres and might try to exact a wider spread but the seller would argue that if he wanted, he could obtain the open rate for his funds. Similarly, if the seller argued that he was paying interest at bank rate on his foreign balances and wanted a wider spread, he would be told that this was a definite borrowing for three months and he is entitled to compensation only at the rate for three months funds.

We have seen that a bank selling forward has four options to cover it. If it buys forward this would not affect any of the rates. If it buys a bill giving funds for that delivery, this also would not affect the rate as the bill would be paid

for at the rate corresponding to the sale. If it buys ready it thus creates a demand in excess of that already existing and this would either tend to curb a rising tendency or to accelerate a downward movement. If it was keeping an open position, it would have to buy at some future time and this is a potential weakening factor in the ready rates of that time. Similarly if the bank buys forward it would, to a certain extent, increase the supply of ready exchange and this would intensify an upward movement or bolster up a falling rate. Thus, the excess of supply or demand in the forward market is reflected in a corresponding excess of supply or demand in the ready market. The banks act as "buffers" which prevent the shocks of one market from going to the other which is not able to bear it so well. They may also be compared to a distributing station which receives electricity at high voltage and supplies it to consumers at low power and in such quantity as they require. When the rates offered are not attractive, they become like valves and shut out the two markets from each other and when the desired margin is available they open out again and normal relations are established.

It is possible that interest rates might change and the forward rates move independently of the ready rates so that the spread was widened or narrowed. Possible trade developments might also produce similar effects, making the spread narrower or wider. In normal conditions the ready rates and the forward rates move together. Thus if the ready rates are T. T. selling  $1/5\frac{3}{4}$ , T. T. buying  $1/6\frac{1}{8}$  and bills buying 90 days  $1/6\frac{3}{4}$  and the spread for forward was a premium of  $\frac{3}{8}$ , the forward rates would be  $1/6\frac{1}{8}$  for T. T. selling,  $1/6\frac{1}{4}$  for T. T. buying,  $1/6\frac{3}{4}$  for buying 90 days bills. But if the spread for forward rates was for some reason increased to  $\frac{1}{4}$ , the ready rates would remain unaltered and the forward rates would be  $1/6\frac{3}{8}$ ,  $1/6\frac{5}{8}$  and  $1/6\frac{7}{8}$ . On the other hand if the spread was reduced, all the forward rates would be similarly reduced. But if the ready rates were  $1/6$ ,  $1/6\frac{1}{8}$ ,  $1/6\frac{7}{8}$  and forward  $1/6\frac{3}{8}$ ,  $1/6\frac{5}{8}$ , and  $1/6\frac{7}{4}$  and the ready T. T. selling changed to  $1/5\frac{3}{4}$  the other rates would change to  $1/6\frac{3}{8}$ ,  $1/6\frac{5}{8}$  for ready and  $1/6$ ,  $1/6\frac{1}{8}$  and  $1/6\frac{7}{8}$  for forward. In other words the

forward and ready rates all move together in ordinary circumstances. It will be noticed that the difference between ready T. T. and bills is also the difference between forward T. T. and bills. But it sometimes happens that banks might expect a rise in the London market and it is possible that the spread between the two ready rates might be different from that between the forward rates.

If a person in London wanted to make a forward contract in rupees what would be the rate? The bank in India buying sterling forward would charge the seller for loss of interest in India. Similarly, a bank selling rupees forward would lose interest in India and would charge it to the buyer. This means that if Indian interest is higher, forward rupees will be quoted at a lower rate than ready and if the conditions are reversed forward rupees will be quoted at higher rates than ready. But as there is little rupee business in London, the spread demanded would be greater and if the client was very keen he would have to pay it, unless the amount was large in which case he could have the transaction put through in India and obtain the advantage of the lower spread. Between other financial centres the forward market is equally active in both centres though there would always be slight differences which would be smoothed off by arbitrage operators as soon as they hear of it.

The element of risk involved in buying or selling exchange on countries with uncertain currencies is well illustrated by the rates now quoted for Shanghai and Hongkong. The silver price on which these currencies are based has been fluctuating widely, having dropped from 1, pence to 13 pence in six months and to 12½ in another month. Consequently, if a bank is offered a 30 days bill it deducts not merely the interest but a bigger amount to cover the risk of a further fall in the price of silver. Similarly, if asked to sell one month forward, it will add a fairly good margin the other way to cover the risk of a rise in the price of silver. Thus while T.T. was equal to 89 rupees per hundred Shanghai taels at 12½ pence silver and 1/5% sterling rate in Bombay, the D.D. (or one month forward) should be 88 for selling but it was actually more than

95 rupees. But banks would have bought at the same time D.D. (or one month forward) on Shanghai at only about 82.

1. A bank buys £20,000 three months forward at  $1/6\frac{1}{2}$  and sells ready at  $1/6\frac{7}{8}$ . If London rate is  $2\frac{1}{2}\%$  lower than Bombay, for three months funds, find the profit made by the bank.

£20,000 at $1/6\frac{7}{8}$	..	..	= Rs. 2,63,464.84
Proceeds of £20,000 sold	..	..	= Rs. 2,65,110.49
Interest in Bombay at $2\frac{1}{2}\%$ for 3 months	=	Rs.	1,646.65
Cost of £20,000 at $1/6\frac{1}{2}$	..	=	Rs. 2,64,827.58
Profit on transaction	..	..	= Rs. 282.89
	or nearly	..	= Rs. 282-14-0

2. A bank sells £17,000 four months forward at  $1/6\frac{3}{4}$  and buys ready at  $1/6\frac{1}{8}$ . If London four months money is  $1\frac{1}{2}\%$  higher than Bombay funds, find its profit on the deal.

£17,000 in London four months would earn £85 as interest

£17,085 at $1/6\frac{3}{4}$	..	..	Rs. 2,26,619.68
£17,000 at $1/6\frac{1}{8}$	..	=	Rs. 2,25,882.35
Profit on the transaction	=	Rs.	737.33 = Rs. 737-5-4

3. A bank in London buys three months forward dollars at  $486\frac{1}{2}$  and three months funds in New York are quoted at  $1\frac{1}{2}\%$  and in London at  $2\frac{1}{2}\%$ . If it sells ready \$100,000.00 at  $487\frac{1}{4}$ , find its profit on the business.

Interest on \$100,000.00 at  $1\frac{1}{2}\%$  for 3 months is \$375.00

\$100,375.00 at  $486\frac{1}{2}$  will cost .. .. £20,632.066

\$100,000.00 at  $487\frac{1}{4}$  will realise .. .. £20,523.346

Interest on this in London for 3 months is £ 128.271

Total proceeds of the sale on due date is £20,651.617

Of this amount it has to use .. .. £20,632.066

to clear New York account.

The profit on the business is therefore £ 29.551  
or £ 29-11-0

## CHAPTER XIX.

### THE BUDLEE.

*"A Quick Change Artist"*

The limits of spread—The budlee—How it arises—Treasury  
Bills—Money for the asking.

Due to various factors there is a seasonal variation in forward sterling exchange of  $\frac{1}{2}d.$  per month upward from about October to March and downward from about April to September, though in some months there may be even rates

for near forward. *The difference in either direction is rarely more than  $\frac{5}{8}$*  because forward business is generally done only up to six months. Beyond this period it is not likely to be genuine business and is probably more akin to speculation. To put the matter in another way, it may be said that an importer cannot have a definite idea of his requirements for more than this period ahead unless he deals in an essential commodity like sugar or bullion and has got a market more or less certain. Similarly, the exporter cannot have any definite idea of his bills more than six months ahead and even if he deals in staple commodities he has to depend upon the purchasing power of foreign clients about which he cannot be positive. The possibility of bills arising out of our agricultural produce depends not only on whether the crops in India are good but more perhaps on whether the other countries producing similar commodities have had a bad season or an even better one.

We have seen that the banks act as intermediaries between these importers and exporters and that they accommodate them very often by selling ready against forward purchases of bills or by buying ready bills against forward sales to importers. This process of buying ready and selling forward or of selling ready and buying forward is very aptly described by the Hindi word "budli" or "budlee"\* which means "changing on". This word is so apt that it has crept into international usage and into standard books.

The budlee arises in the cases we have seen, from the desire of other parties to transact forward business with the bank. But there are some occasions when the bank itself has to do the budlee because it has to change its position or because its views with regard to the possibilities of the market have been changed by some factors. We have seen that the option of taking up a forward contract lies with the buyer of T.T. (and, of course, of D.D.) but that the option of delivery is with the seller of the bill. Consequently, in the slack months banks are keen to transfer their Indian funds to

\* Mr. W. F. Spalding refers to this operation in his book on "The London Discount Market" as "budla" which means vengeance !

London as they are comparatively idle here, and they therefore, take up the purchases almost on the first day of the contract period. The exporters are not so keen to deliver the bills as they do not stand to lose much owing to the season being slack and the bills therefore come forward towards the end of the contract period. The bank may thus find that it would be out of funds in London for some days which it has not calculated for.

Similarly, in the busy season when money is tight, the banks would not take up their contracts until the end of the contract period but the exporters, being anxious to liquidate their overdrafts and also to obtain fresh money to repeat the transactions, would deliver the bills as soon as possible after the contract period begins. The bank then would find itself short of money in India having to pay the exporters and to wait for the buyers of T.T. to pay for their purchases.

The bank could, in the first case, wait for some time and take no action but it might have come near its limit of overdraft with the London office and it must then put it right by buying ready and selling about one month forward. In the second case it might not care to adjust the position but it might happen that it has borrowed all it can in India and it would be to its advantage to sell ready and buy about one month forward rather than borrow here.

It may also happen that the client who sold the bill might find it is not ready and would not be ready within the stipulated time and would ask the bank to give him an extension. The bank has, of course, to accede to the request and buy a ready bill or ready T.T. and sell forward to suit the extension required.

It is true the bank would lose on the transaction at such times but it would usually pass it on to the defaulting client. There has not been uniformity in regard to this charge, Bombay calling for interest at Imperial Bank of India rate for the defaulting period and Calcutta calling for  $\frac{1}{2}$ d. per week which is equivalent to nearly 9%. Since this matter was brought to the attention of the Central Banking Committee the Bombay custom is being adopted elsewhere.

It stands to reason that, as the bank cannot but fulfil its sales contract, <sup>of</sup> <sup>the</sup> there must be some deterrent influence to make the exporter abide by his contract. If the penalty were too low it would permit him to regard it as a speculation in exchange <sup>any</sup> <sup>only</sup> <sup>of</sup> <sup>the</sup> But as  $3\frac{1}{2}\%$  per month and brokerage and other expenses <sup>id not of</sup> <sup>the</sup> <sup>bank</sup> more than 3%, a maximum charge of <sup>should</sup> <sup>adequate</sup> compensation to the bank and effect <sup>pen</sup> <sup>would</sup> <sup>be</sup> the customer. If he demands only a week's extension <sup>the</sup> <sup>bank</sup> need not do any 'budlee' to tide over the situation. But if it is for more than that, the bank might even make a net profit on the 'budlee'. If the delivery was for the slack months the bank would make a profit on the 'budlee' itself and also in the charge it would make to the clients.

The process of 'budlee' arising out of such situations does not require pushing forward the business for more than a month. But it may happen that a bank which has sold forward might desire to get ready funds in India and might make a 'budlee' for two to six months. Similarly, a bank, anticipating high exchange rates later on account of export bills might have sold for the earlier months of the busy season but, not finding bills, it may decide to buy ready when the time came and sell two to three months forward. Lastly, the issue of the Government Treasury Bills at attractive rates might induce the banks to sell ready T.T. by even overdrawing in London and buying forward as for the date of maturity of the Treasury Bills. As Treasury Bills may be for 3 months or 6 months the 'budlee' would also be for 3 to 6 months. Nine months Bills are generally not attractive for exchange banks as the period of locking up of funds is too long and usually the spread for 9 months 'budlee' is prohibitive, chiefly because overdraft in London for such a long period is not encouraging.

The ready rates on London cannot go much above  $1/6\frac{3}{4}$  because the Government will then buy any amount of sterling at that rate and cannot go much below  $1/5\frac{4}{8}$  because the Government will then sell any amount at that rate. The sight and bill rates are bound up with the ready T.T. rate and move together with it with fixed differences between them of



$\frac{1}{8}\frac{1}{2}$  for sight and for bills of an amount, and they therefore, London discount rate. But there is no set day of the contract movement of forward rates. Theoretically to deliver the bills as go much below  $1/5\frac{4}{8}\frac{9}{4}$  nor much above  $1/5\frac{4}{8}\frac{9}{4}$  to the season being had to buy at  $1/5\frac{4}{8}\frac{9}{4}$  it will not sell forward towards the end possibly at  $1/5\frac{4}{8}\frac{9}{4}$ . Similarly, if one thus find that it would surplus it will only buy them at a rate days which it has not to sell T. T. at  $1/6\frac{3}{8}$ , that is, it will not of T. T. at  $1/6\frac{3}{8}$ , possibly  $1/6\frac{7}{8}$ . If the client's tightness on a forward rate when ready is near these limits, he will have to compensate the bank for taking the risk and the limits of the forward rates would then be  $1/5\frac{4}{8}\frac{9}{4}$  and  $1/6\frac{7}{8}$ . If, however, there was a fear about the adequacy of gold assets in the hands of the Government when the rate was near  $1/5\frac{4}{8}\frac{9}{4}$  or a doubt of its capacity to buy at  $1/6\frac{3}{8}$ , the rate might jump away to any extent from these limits.

When a bank puts through a 'budlee' transaction it is shifting the influences on ready rates to the forward rates. Thus, if the ready rate is rising and the bank buys ready, it has to sell forward and the firmness of the ready rate is transferred to the forward rate. If the ready rate is falling and the bank sells ready it has to buy forward and the weakness of the ready rates is transferred to the forward rate. The 'budlee' is therefore not merely a 'budlee' of the bank's position in exchange but it also becomes a 'budlee' of the factors influencing the ready and forward exchange rates.

When the period of tight money in India begins in November the exchange banks prefer to bring out money from England rather than borrow in India. This means that a heavy supply of ready exchange is created and a correspondingly heavy demand for remittances in April when they would return the money to London. The ready rate goes up and the forward rate goes down so that the spread between ready and forward widens further than before. The banks which try to do the 'budlee' later in the season might find themselves compelled to pay a difference in the rate and brokerage for a short time and the result might be the same as if they borrowed in India at the prevailing high rates for money.

It stands <sup>1</sup>/<sub>1</sub> ready as if every year a good deal of money sales contract, there <sup>1</sup>/<sub>1</sub> mere asking" out of the forward rate the exporter abide by <sup>1</sup>/<sub>1</sub> one could buy ready at  $\frac{1}{6}$  and sell it low it would permit  $\frac{1}{5\frac{1}{2}}$  there is a profit of about 350 rupees exchange <sup>1</sup>/<sub>1</sub> but as  $\frac{1}{3\frac{1}{2}}$  lakh of rupees. There would also be expenses <sup>1</sup>/<sub>1</sub> ld not of 500 rupees at 2% or, totally, rupees 850. charge of <sup>1</sup>/<sub>1</sub> only should be remembered that if the profit was really attractive and effective <sup>1</sup>/<sub>1</sub> should enter into competition for it and shut out <sup>1</sup>/<sub>1</sub> extraordinary investor. Rs. 850/- for three months or Rs. 3400/- for a year is just as welcome to them as to the latter. The explanation is that during this time money in India is very tight and 6% is very easy to get. This will give an earning of Rs. 1500/- for the 3 months and the profit out of the exchange is not attractive. On the other hand, if the business is transacted in the slack season there will be a loss on the exchange part of the business.

Some of the big commercial houses in India also keep open positions in exchange which they push forward by budlees. They buy and sell ready against forward as funds are required in India or in London. The budlee is also done by some Indian firms of good standing for the same reason and by some of the bullion importers who have the knack of using the budlee to hedge themselves against fluctuations in the price of gold and more particularly silver. Several of them buy or sell forward silver in London and carry corresponding positions in India and the budlee is the only means of making up a loss in one centre by a gain in another.

1. A bank buys ready and sells one month forward at a difference of  $\frac{1}{3\frac{1}{2}}$  against it. Allowing for brokerage @  $\frac{1}{3\frac{1}{2}}$  % and cable charges Rs. 5, what is the gain if it charges the client 6% for the month, assuming that the rate is  $\frac{1}{6}$  and the sum £2,000 ? \*

6% interest for one month on £2,000 is £10 or Rs. 133 5 4

$\frac{1}{3\frac{1}{2}}$  difference in the rate = Rs.  $\frac{2000 \times 240}{18 \times 18 \times 32}$  .. = 46 4 9

Cable charges and brokerage at  $\frac{1}{3\frac{1}{2}}$  % .. .. = 13 5 4

Total .. .. = 59 10 1

Profit on the arrangement = 73 11 3

2. A client fails to take up his three months bill contract for £2,500 at

1/6. The bank finds it has to buy in the market at  $1/5\frac{1}{8}$  for a similar bill ready delivery. What should it charge its client?

Equivalent of £2,500 at $1/5\frac{1}{8}$ ...	...	Rs. 33,449 7 4
Equivalent of £2,500 at 1/6 ...	...	„ 33,333 5 4
The difference to be charged is	...	„ 116 2 0

3. A bank sells £3,000 ready T.T. at 1/6 and buys three months forward at  $1/5\frac{3}{8}$ . If it tenders the amount for three months Treasury Bills at Rs. 98-8-0 and it has to pay interest in London at 3% what is the profit on the transaction allowing Rs. 10 for cable charges and brokerage  $\frac{1}{32}\%$ ?

£3,000 at 1/6 is Rs. 40,000 and this can be invested in Treasury Bills of the face value of Rs. 40,600 with Rs. 9-0-0 left over. The interest earning in India thus amounts to ...	...	Rs. 609 0 0
Interest at 3% on £3,000 for 3 months is £22-10-0; £3,022-10-0 at $1/5\frac{3}{8}$ is ...	„	40,510 15 9
Plus cable charges and brokerage ...	„	22 10 6
Net amount spent above Rs. 40,000 =	Rs.	533 10 3
Profit on transaction is	...	„ 75 5 9

4. A bank sells £5,000 ready T.T. at  $1/5\frac{3}{8}$  and buys six months forward at  $1/6\frac{1}{8}$ . It invests the proceeds in Treasury Bills at Rs. 97-4-0. If interest in London is  $3\frac{1}{2}\%$  what is the profit allowing cable charges Rs. 10 and brokerage at  $\frac{1}{32}\%$ ?

£5,000 at $1/5\frac{3}{8}$ is Rs. 66,782-9-9. This can be invested in Treasury Bills of the face value of Rs. 68,600 with Rs. 69-1-9 left over and will realise ...	Rs.	68,669 1 9
Less brokerage ...	„	21 5 6
	Rs.	68,647 12 3
Interest in London at $3\frac{1}{2}\%$ for six months is £87-10-0.		
£5,087-10-0 at $1/6\frac{1}{8}$ is	Rs.	67,715 12 3
Cable charges ...	„	10 0 0
	Rs.	67,725 12 3

Profit on the transaction is Rs. 922 0 0

## CHAPTER XX.

### FINANCE OF EXPORT BILLS.

*“To speed the parting guest”*

The outward bill—Continental bills—Bills on paper standard countries—Risk in buying bills—Documents for bills—Clean bills—*Tel quel* rates.

When a person exports goods from India to another country we have seen that he must usually wait for a period of four

to five months before he can obtain payment. He could charge the importer interest for this period but that is not like ready money as the interest would not recompense him for the delay in payment. If he had the money, he could buy some more goods and make some more profit on the trade which would be several times the interest charge. If, therefore, someone would pay him for the goods he would be glad to allow that party to deduct some amount from what is due to him. This deduction or discount on the bill is generally made by the exchange banks who thus render him a valuable service. But they go further and act as his agent until the goods are paid for. This may perhaps be due to their desire to protect the value of the goods against which they have made the loans.

The items that go to make up this discount have been explained in another chapter and the chief of them is interest. For the period of transit the bills are treated as sight bills and interest is taken at bank rate here. The interest for the period of waiting in London depends on whether the bill calls for documents to be delivered against payment, a D/P Draft, or for them to be delivered against acceptance, a D/A Draft. A bill of the former class may be retired any moment and has to be kept in the portfolio of the holding bank, which naturally claims interest for the period at the bank rate in London. A bill of the latter class can be handed over to the discount market after acceptance and the rate claimed is therefore usually the market rate which is below bank rate by one quarter to one per cent.

The difference between sight bill rate and 90 days bill rate thus depends for D/A bills on the market rate in the centre on which the latter are drawn and on bank rate in the case of D/P Bills. Taking the case of London, the market rate usually remains between 2% and 4% though in exceptional cases it has gone as high up as 6% while bank rate is usually between  $2\frac{1}{2}\%$  and  $4\frac{1}{2}\%$ . The interest on 18 d. for 93 days at 2% is about  $\frac{3}{32}$  d. while at 4% the difference is  $\frac{3}{16}$  d. Thus the difference or 'spread' between sight rate and fine bill rate may be as low as  $\frac{3}{32}$  d. or as high as  $\frac{3}{16}$  d. though if the London market rate is 6% it may be  $\frac{9}{32}$  d. Similarly

the spread between sight rate and D/P bill rate will be between  $\frac{1}{8}$  d. and  $\frac{7}{32}$  d. or even as much as  $\frac{5}{16}$  d.

The method of calculating the bill rate is shown below.

To find the rate for a 60 days D/A bill T.T. being  $1/6\frac{3}{32}$  buyers and interest in London being 5%.

$1/6\frac{3}{32}$  d. =  $18\frac{3}{32}$  =  $5\frac{72}{32}$  d. ... = 579 units.

The D.D. rate is therefore = 580 „

Interest for 63 days at 5% = 5.01 „

Bill stamps at 1 per cent. = 0.29 „

Trade risk etc. .. .. = 1.00 unit

6.30 units or 7 units.

The bill rate should therefore be  $1/6\frac{1}{8} + \frac{7}{32} = 1/6\frac{11}{32}$  d.

The bill rate quoted in India is for bank acceptances and the last item is not allowed for and the rate will be  $1/6\frac{1}{8} + \frac{7}{32} = 1/6\frac{5}{8}$  d.

When the bank is in credit in London, the new funds will earn interest only at the London deposit rate which is usually 2% below bank rate and, consequently, the bank may prefer to hold the bill in its own portfolio rather than discount it. On the other hand if the bank is in debit, it is charged bank rate for the overdraft and it will be anxious to discount the bills as soon as possible. A bill kept in portfolio means selling the sterling cover 2 or 3 months later than if it is discounted and unless the bank can sell forward exchange for that delivery at as good a rate as ready, discounting is preferable. During July to September the forward rates are not favourable but from October to February they are favourable. But this being the tight money season in India banks must be anxious to bring back the funds as soon as possible and must discount. Holding in portfolio would thus be confined to bills paid for between April and August.

Bills on the continent are subject to another period of waiting for presentation at the foreign centre (where local bank commission and bill stamps will have to be paid) and remitting the proceeds to London. They are therefore usually bought at a difference of  $\frac{1}{32}$  d. as against London bills. Thus, if a good London bill is quoted at  $1/6\frac{5}{16}$ , the same type of continental bill will be bought at  $1/6\frac{5}{16}$  provided both are payable at sight. But if they are payable after a certain period, then the interest charge on a continental bill will invariably

be London bank rate for the whole period as the purchaser is out of London funds all that time. This would result in a wider margin of difference by  $\frac{1}{8}$ d. over a London bill. These bills are not therefore very popular with British banks but are naturally popular with the French and Dutch banks. The rate of interest which they work on will not be the London market rate but the bank rate of the centre on which the bills are drawn.

In the case of bills on paper standard countries the purchase of bills becomes a serious risk. Taking the case of Argentina, the position becomes very difficult for the banks in India as the time element becomes longer and the risk is therefore greater than for a bank in New York or even London. The bill will have to go through London and thence probably through New York, and the transit time will be as much as two months. If it is a three months bill this would make it five months before payment is due. But T. T. on Argentina cannot be sold in Bombay, and the bank in Argentina usually sends a 90 days sight bill on London, to the London agent of the Bombay bank. This would mean another five months. The Bombay bank would thus be out of funds for about ten months and an exchange bank would not desire to lock up its funds so long. Moreover interest cannot be claimed for late acceptance and the bank may lose on this account. Though the bills may be drawn in sterling and payment insisted on by draft on London, the credit of a paper standard country is so low that the purchase of a bill is fraught with extra risk. The information regarding drawees in such remote parts is also scanty and banks in India generally turn down such bills. They may take them for collection and may advance some part of the value if the drawer is very good.

In actual practice, the purchase of bills is not so simple. It is rarely that an exporter brings a bill for sale. What generally happens is that, when he has an order to sell goods, he has to quote a sterling price and he has to remember that it will take him some time to ship the goods even if they are ready in his hands. It may take anywhere between one month and three before the bills are ready. But he has to be sure

*of the rupee amount he can get by selling his bill.* Consequently, he approaches the bank with the proposition that it should make a contract for the purchase of bills deliverable one or three months later as the case may be. If the bill is for May delivery, it could be sent to London and discounted sometime in June and the T. T. against it would have to be sold for June delivery. The bank takes the forward rate for June delivery and adds stamp and interest and other charges and determines the rate at which it can buy the bill, making sure that its profit on the transaction will permit of a brokerage being paid if required and to give a margin for the risk involved in buying trade bills. This is not all. We have seen that the bills might be delivered in the beginning or end of May and the T. T. taken up in the beginning or end of June and the bank will have to be prepared to meet these contingencies.

Another risk that it runs is that the London rate may rise and the discount rate move up in consequence. Against this it has two protections. One is that if it loses in this way over some transactions, it gains on some others when the rate moves down in London. Secondly, it does not calculate the interest charge to such a fractional extent when it quotes the rate. As will be seen from the example given, the rate quoted is high enough to take care of such contingencies.

In abnormal times, such as those prevailing in most countries between 1918 and 1925, there was another element of risk namely that of the heavy fluctuation in the basic rate of exchange. Thus a contract in sterling might have been made in India when the basic rate was  $1/4\frac{1}{2}\%$ , but when the time for delivery of the contract came, the rate might be  $1/4\frac{1}{4}\%$  or  $1/5\frac{1}{2}\%$ . It might be thought that if the sale of T.T. was also for the correct delivery, this risk was eliminated. But the risk arises when the buyer of the T.T. or the seller of the bill backs out of the contract for some reason. If the buyer of T.T. is a bank this risk does not exist. But the seller of the bill might do so and the bank will have to stick to its half of the bargain and try to resell the exchange involving a loss on the transaction. It is entitled, in ordinary

circumstances, to compensation from the original party, but it may not always be possible to enforce this obligation.

Bills must be accompanied by documents if they are to be bought as such. The documents usually called for are:—

1. Bill of Lading
2. Insurance policy or certificate
3. Commercial invoice, certified if necessary
4. Certificate of origin in some cases

These must be scrutinized to find if they are in order and the bank should be satisfied about there being no irregularity. A person negotiating a bill through a bank, whether it be drawn under a credit or otherwise, must furnish the bank with a letter of hypothecation. The idea is that as bills of lading are usually made out "to order and blank endorsed",\* that is, the goods are deliverable to the holder, it is proper to have evidence that the documents have been duly assigned. It is also of use in cases of bankruptcy of the drawer as otherwise the trustee may claim the goods as part of his estate. The letter of hypothecation describes the nature of the goods covered by the bill and states that the documents are assigned to the bank for security for payment of the drafts; that, in cases of dishonour, the bank may sell the goods and recover the balance from the drawer; and that, if the bank incurs any loss through the purchase of the bills, the drawer will see that the bank does not suffer. The letter of hypothecation may be for a single bill or a general one covering all bills negotiated by the particular drawer. It would not be forwarded with the bills but retained by the buying bank.

When the bills have been scrutinised they should be set off against any contract if such exists, and if not, cash payment must be made at the agreed rate of the day. If set off against a contract, it must be ascertained whether the delivery is within the time limit of the contract. If it is too late, a charge is made on account of late delivery. In general, a bank would not pay for a bill if it cannot be sent by the foreign mail in a day or two. Mail day in Bombay is Saturday; Thursday

\* If the bill of lading is endorsed to the bank, it incurs no liability in endorsing the bills to negotiate the documents to others. But it is safe to endorse "Without recourse." Q. 609, Questions on Banking Practice of the London Institute of Bankers, 7th. edition.



in Calcutta, Madras and Karachi ; for Rangoon it is Tuesday *via* Calcutta. Friday evening about 3 P.M. is the latest time for receiving bills in Bombay ; Thursday 3 P.M. in Calcutta and Madras ; Wednesday 3 P.M. for Karachi and Monday 3 P.M. for Rangoon. Bills received after this time would be treated as having been delivered for the next week's mail and though a penalty may not always be called for, payment would only be made late in the following week. The bills are then forwarded to London or the foreign centre on which they are drawn, together with a covering advice.

Export bills sometimes appear as "clean" bills. The "Eastern Houses" like E. D. Sassoon, Andrew Yule, Ralli Brothers, to mention a few, export and import goods in such quantities that they usually try to keep the exchange profits to themselves by settling accounts between their Indian and foreign offices, instead of selling bills and buying exchange back again. But it often happens that they have to borrow money temporarily. They do it in India by taking call money and one month to three months funds from the banks and they generally pay the same rate as the banks. They also borrow in London by bills under acceptance credits and transfer the money to India through budlee operations. They sometimes draw bills on their London offices and sell them here.

These bills may or may not be accompanied by the documents. In the latter case they are referred to as "house paper" or in common parlance, "one name paper", "pig on pork", and "kites". The last term is to indicate that they are not adopting the best means of drawing on the branch. For example, the London Office could sell T.T. on India or the Indian Offices could sell T.T. on London or they could at least sell demand drafts. The bills are, however, bought by the British banks at the same rate as first class bills but other banks are rather shy of them for, after all, there is only the standing of these houses behind them and this may mean all or nothing. If things go on alright, one is happy, but if anything goes wrong, there is no more security in these bills than there is in a promissory note, while in the case of ordinary bills, there is recourse against the goods and the

various parties to the bill. Still, it is estimated that about 100 crores worth of goods move in both directions from and to India and there is outstanding at any time several crores of their obligations.

If ordinary exporters draw bills on individuals without being under credits, banks would not pay for them if they are not quite satisfied about the reliability of the drawee or if they have no means of assessing the drawer properly. But such bills would be taken for collection and payment in India made after payment has been made abroad. If the exporter so desires, cable information of the "fate" of the bill might give him the funds about 15 days earlier.

There is in use in the European countries a rate known as the "*tel quel*" rate which is an adjusted rate. How the word crept in is not clear but it means "unchanged" or the actual rate of exchange. It is the rate for bills which have been held in portfolio for some time. Thus, supposing a bank has a bill held for 39 days out of 93 days, the rate could be worked forward as for a bill due 54 days hence, or it could be treated as a bill for which 39 days have elapsed and the rate worked backward from the 90 days bill rate. If the sight rate for a sterling bill in Paris is 123.75 and London market rate is 3%, the *tel quel* rate for this bill should allow interest for 54 days or .55 in the rate which should be 123.75—.55 or 123.20 or, taking the rate for 90 days bills as 122.80, and allowing interest for 39 days we get the rate as 122.80 plus .40 or 123.20.

*Tel quel* rates in India might arise in two cases. If the buying bank has kept the bill in its portfolio in London after acceptance it might like to discount it for obtaining ready sterling. Or a bill drawn 60 or 90 days after date, might have been kept in India for some days before negotiation and the rate will be calculated as follows:—

If sight rate is  $1/5\frac{1}{2}$  and the London bank rate is 3%, and the bill is a 90 days bill kept here for fifteen days, it has 78 days more to run of which about fifteen will be the same as for the sight bill. Allowing interest for 63 days or: 575 points, we get the rate should be  $575 + 2.97 + 0.29$  points or 578.26 or 579 points or  $1/6\frac{3}{4}$ d. Or if the

corresponding 90 days rate was  $1/6\frac{1}{8}$ , the interest for 15 days is 0.71 points and the *tel quel* rate would be  $1/6\frac{1}{8} - \frac{1}{32}$  or  $1/6\frac{3}{32}$  d.

1. A sixty days date bill on Japan which is 7 days old has to be bought on the basis of transit time 25 days and interest at 6%. What is the rate? (D.D. on Japan is 135).

The bill has to run 53 days of which 25 days are in transit.

There remain 28 days with interest at 6% on 135 i.e. .62 points.

The rate required is  $135 - \frac{1}{8}$  or  $134\frac{3}{8}$  or  $134\frac{1}{4}$ .

2. The T.T. rate on London is  $1/5\frac{3}{32}$ . What is the rate for a bill payable 60 days after date D/P (London Bank rate 3%)?

The D.D. rate is  $1/6$  or 576 units.

Interest should be allowed for 48 days at 3%, that is, 2.27 units.

Stamp charges amount to 0.29 units.

The difference is 2.56 or 3 units and the rate should be  $1/6$  plus  $\frac{3}{32}$  or  $1/6\frac{3}{32}$ .

3. D.D. on London is  $1/5\frac{29}{32}$  and London Bank rate is  $\frac{1}{8}\%$ . What is the rate for a 60 days sight D/P bill?

$1/5\frac{29}{32}$  is 573 units and interest for 63 days at 3% is 2.97 units and stamps 0.29 or a total of 3.26 or 4 units.

The rate desired is  $1/5\frac{29}{32}$  plus  $\frac{4}{32}$  or  $1/6\frac{1}{32}$ .

4. The London D.D. rate being  $1/5\frac{1}{8}$  and discount rate  $2\frac{1}{4}\%$ , what is the rate for a 90 days sight D/A bill?

$1/5\frac{1}{8}$  is 574 units and interest for 93 days at  $2\frac{1}{4}\%$  is 3.29 and stamps 0.29 make 3.58 or 4 units. The rate desired is

$1/5\frac{1}{8}$  plus  $\frac{4}{32}$  or  $1/6\frac{1}{16}$ .

5. The Paris Bank rate is 4% and T.T. on Paris is 927. What is the rate for a three months sight bill if the spread between T.T. and D.D. is three points?

The D.D. rate is 927 plus 3 or 930.

Interest on this for three months at 4% is .. 9.30

Stamp charges at  $\frac{1}{8}\%$  .. .. . 0.46

The spread should be 9.76 or 12 points to cover trade risk and the rate quoted should be 930 plus 12 or 942.

6. The New York T.T. rate is 276. What is the 90 days sight D/A Bill rate with interest at 6% for transit time of 25 days and interest in New York at 4%?

T.T. rate is 276; interest on this for 25 days at 6% = 1.13 and interest for 93 days at 4% = 2.81.

The spread should therefore be 3.94 or 4 points and allowing for trade risk should be 5 points and the rate is 271.

7. A bank sends a 90 days sight D/A bill for £2,745 to London for discount, bought at  $1/6\frac{1}{32}$  and sells at  $1/5\frac{1}{8}$  T.T. for the due date. If the discount rate is 3% and Indian money rate is 6% and brokerage on the sale is  $\frac{1}{32}\%$  ascertain the bank's profit.

£2,745 at  $1/6\frac{1}{32}$  is .. .. = Rs. 36,473 5 7

Interest in Bombay at 6% for 15 days = Rs. 89 15 0

Equivalent of £2,745 on due date = Rs. 36,563 4 7

Discount on £2,745 at 3% for 93 days is £20-19-8.

Amount realised in London is

£2,724-0-2 which at  $1/5\frac{1}{8}$  .. = Rs. 36,702 4 0

Less stamps .. Rs. 18 13 7

brokerage at  $\frac{1}{32}$  % .. 11 7 6 Rs. 30 5 1

Amount realised by sale .. = Rs. 36,671 14 11

Profit on transaction .. .. = Rs. 108 10 4

8. A bank buys a 90 days bill for £3,500 at  $1/6$  and sells T.T. against its date of maturity at  $1/5\frac{2}{3}$ . If money in Bombay is worth 2%, allow for bill stamps and brokerage at  $\frac{1}{32}$  % and find the profit.

£3,500 at  $1/6$  .. .. = Rs. 46,666 10 8

Interest for 108 days at 2% in Bombay = Rs. 276 2 7

Cost of £3,500 on due date of bill = Rs. 46,942 13 3

£3,500 at  $1/5\frac{2}{3}$  .. .. = Rs. 47,240 12 6

Less bill stamps .. Rs. 23 10 0

brokerage .. 14 12 0 Rs. 38 6 0

Net proceeds of sale of sterling ... Rs. 47,202 6 6

Profit on the transaction is , ... Rs. 259 9 3

9. A bill on Italy for Liras 250,000·00 has to be bought in London when the sight rate is 92·50. If the usance is 60 days and the Italian Bank rate is 4% find the rate at which it should be bought. If D.D. can be sold against it at 92·40 what is the profit?

The sight rate is 92·50

Interest at 4% for 63 days is ·64 or ·65

The rate should be 92·50 plus ·65 or 93·15

Liras 250,000 less discount is Liras 250,000·00—1726·20 or Liras 248,273·80.

This amount sold at 92·40 would give ... £2,686·946

The cost of Liras 250,000 at 93·15 is ... £2,683·843

Therefore profit is £3·103 or £3-2-1.

## CHAPTER XXI.

### CREDIT INFORMATION.

*"What think you of yon Cassius?"*

What is credit?—The Three C's—Credit agencies—Conditions in India—Credit records.

Every bank has a credit department from whose records its officials can find the extent of financial assistance which

may be rendered to the various clients. This credit department is more valuable for the foreign exchange bank because its business deals not only with the credit of local clients but of businessmen all over the world. The foreign exchange bank has therefore to have on its files information regarding the standing of all important firms in the foreign countries with whom its clients deal and must maintain it up-to-date by frequent references to foreign branches and correspondents. There will also be clients of ordinary standing about whom it will obtain information for its clients which it will also use in conducting its own business.

The basis of judgment of a client's credit rests upon the three C's, namely, character, capacity and capital. Character is of importance on account of the moral risk in dealing with him and the assurance it gives that he will not hide his true situation from those with whom he deals. Capacity is the test of the business risk in dealing with him and is connected with the technical side of his operations and the point as to whether the kind of business he transacts is one involving undue risks. Capital is the financial reserve behind the man, the last resort of his creditors if his business should so far deteriorate that he is unable to meet his obligations without closing up his business. This may be in the form of funds invested in the undertaking, or property owned by him.

The relative value of these three factors varies in each country. In some countries like England character is the chief test and unsecured credits from banks are believed to be nearly 40% of the total advances. Character is also of great importance for the exchange bank because the ultimate value of the clients' documents lies in the integrity with which he conducts his business and the scrupulousness with which he fulfils his contracts. But the war has lowered the prestige of all foreign clients in the eyes of banks. Capacity and capital are the chief tests in India and unsecured advances are very uncommon. In fact, a tradition has been built up that the borrower should furnish 125% security for his loans. This idea has been strengthened by the form of schedule G called for from banks under the Indian Companies Act requiring

classification of loans as fully secured, partly secured and unsecured, leaving the public with the impression that the last class is undesirable. The value of character has been well emphasised by Mr. R. G. Gallaher in his Presidential address to the London Institute of Bankers (Journal, November 1925) where he places 'the character and standing' of the client above nearly a dozen other factors. The credit standing of a client is therefore the 'breath' of his commercial life.

Foreign credit data are not easily obtainable because they have to be obtained mostly through banks in other places which would be reluctant to impart information of a definite nature for which they might be held responsible. There are, however, reporting agencies in some centres such as Seyd's, Bradstreet's and Dunn's Agencies, who impart accurate details on payment of a certain fee. In certain countries the difficulty of obtaining information is enhanced by the damages awarded in suits instituted by people whose credit abroad was damaged by such information. In fact, this difficulty has made the work of reporting agencies so risky that they have often settled heavy claims with firms about whom they have reported rather than fight them in the law courts. It is only a bank that seems by law to be protected against such libel action.

Due to these causes the reply of a bank abroad to an enquiry is couched in such ambiguous terms as 'moderately good for his engagements', 'considered honourable', 'of moderate means', 'means unknown', 'reported good standing', and even this is subverted by a clause that 'the information is furnished as a strictly confidential matter and without responsibility on the part of this bank'.

In the United States, the National Association of American Manufacturers has a credit service department both for internal business and for foreign trade. Their chief aim is to promote foreign trade for their clients and the organization renders good service in this direction.

Very often some valuable information can be obtained from the balance sheet of the parties but this is not thoroughly reliable because it may not always be audited by a chartered accountant. But in some countries the statements are always

correctly prepared because of liability under the common law. Thus, in 1922, a private banker in England was sentenced to a long term of imprisonment for falsifying his accounts even though he was a member of Parliament. As a general rule except in England and the United States the balance sheet is not very reliable. Assets may be over-estimated, doubtful debts not provided for, or loans may have been raised since the date of the balance sheet. Moreover, it is not always easy to follow the classifications of accounts by foreigners.

In India the difficulty is further enhanced by the fact that most clients keep their accounts in the vernacular and a statement of accounts prepared by them would be unintelligible to the European bank employees who have therefore to depend on whatever information is imparted to them by Indian clerks who often base their ideas on rumours in the market. It was admitted, in fact, by the Exchange Banks Association, in its evidence before the Central Banking Committee, that European employees had more occasion through social intercourse of judging of the standing and responsibility of their European customers. On the other hand, it is not possible for the ordinary Indian merchant to incur the expenses of a regular audit by chartered accountants, as desired by the Association. There is also the defect that Indian traders rarely distinguish between their business and their personal wants. The Imperial Bank of India, however, stated that it never had any difficulty in obtaining all the information it wanted about Indians.

Credit information is often obtained directly by some of the big manufacturing concerns by sending out representatives to various countries with whom they trade. These men obtain from the spot reliable reports of their foreign buyers. They also recommend the type of credit that could safely be given and the extent to which business may be done. Whether the terms are D/A or D/P, 60 days or 90 days, how much of the goods may be left in their hands, would all be decided by them.

The credit information of the banks will consist of two sets of cards. One would give the general information on the party, to be revised from time to time. The second would show the limit up to which business may be done, the actual

business outstanding and the time that the obligations would mature. This set of cards will have to be referred to before any new business is entered into as it is quite possible that the credit limit may thereby be exceeded. It may also be that, when a party presents a bill for sale, the bank may have to decline it as the limit on the drawee may be exceeded.

In an exchange bank the credit limit would apply to documents purchased from him, to advances for exports, advances against imports, credits opened for him, goods released under trust receipts and general credit extended. It would also include the risk of forward contracts entered into with him and would have special reference to the terms he extends to his customers.

## CHAPTER XXII.

### THE DISCOUNT MARKET IN LONDON.

*"The non-pareil of all the world"*

The market's resources—Eligible bills—London rates—Other rates—London market rates—Access to London market.

The discount market in London works on some of its own money, some deposits from the public and some short term advances from the banks and finance houses. These loans correspond to what are known in India as call loans but are often lent for seven days and, as the banks are satisfied with getting the rate they allow their depositors on such temporary surpluses, the rate is 2% below bank rate. These funds enable the discount market to buy the best class of bills at about  $\frac{1}{2}$ % below Bank of England rate. The loans from the banks and finance houses amount to about £150 millions at any time.

Every month when the banks publish their monthly statements they have to increase their cash reserves in the same way as banks elsewhere do ;\* and as there is a tradition in

\* Report of the Macmillan Committee on Finance and Industry in England, 1931.



England as in Germany, that the banks should not be indebted to the Central Bank, they call in their loans from the market. The discount houses have then to borrow temporarily from the Bank of England, when they are referred to as being "in the bank." The borrowing may be by rediscounting bills when the rate will be bank rate, or by taking loans against their security in which case the interest would be at one half per cent above bank rate.

The British Government receives quarterly taxes and money is withdrawn from the banks and placed to the credit of the Government account with the Bank of England, resulting in a scarcity of bank cash which is passed on to the discount houses. This would make them raise the rate of discount until the funds flowed back to the banks through payment of Government dues to the public. This would take about a week to ten days and the rate would then drop to normal.

The discount market does not keep any reserves but depends for its cash requirements on its capacity to borrow further by offering higher rates for money or to refuse to lend by charging a higher rate of discount. What George Clare wrote in 1892 in his "Money Market Primer" is true even to-day:—"This call money the broker employs in the discount of bills and, as every shilling of it bears interest, every shilling must likewise earn interest or bring a loss. Consequently, he cannot afford to keep a reserve, and as a matter of fact he makes no serious provision against withdrawals, but relies on being able to repay by letting his bills run off or, in case of need, by borrowing at the Bank."

The discount market will only invest in bills that are "clean", that is, to which documents are not attached. These bills, if originally documentary, must have the documents detached. For this reason, D/P bills are not wanted by the market as these must be held ready for the drawees to retire at any time they like. D/A bills or clean bills after acceptance are the ideal form of investment for the market. The market is also interested in British Treasury Bills but these suffer from the defect that the Bank of England would only lend on them.

The "market rate" in London is the rate at which the best class of trade bills, such as bank acceptances, will be discounted. It is generally  $\frac{1}{2}\%$  below bank rate but sometimes it is very near bank rate and sometimes less by 1%. In the former case the Bank does not worry about it but, in the latter, it forces the market to raise its rate by withdrawing the surplus funds available to it by open market operations. Thus, if the Bank sold securities, the public would withdraw money from the banks to pay for them and their bank cash becomes low and they call in the money from the market which has to go to the Bank, which then dictates its terms, and makes the market follow its policy. There have also been some occasions when the London market rate has been slightly higher than the Bank of England rate.

A shipment of gold from the Bank of England would be immediately reflected in a rise in the market rate. The gold withdrawn represents the blance of some bank with the Bank of England and that bank would have to call in its loans from the market. Similarly an influx of gold into the Bank's vaults would mean that some bank had acquired more bank cash and it would lend more money to the market and the market rate would go down. In both cases the market rate would probably be an indicator of a movement in the bank rate itself.

A rise in the market rate sometimes comes about by the temporary withdrawals of foreign funds in London for payment of interest and other obligations there. But the money would probably come back to the market in a few days time. Foreign funds may also flow out if the bank rate of some other country were raised above the London rate.

A rise in the market rate of a permanent character and in comparison with other rates is a signal for foreign funds to flow into London like mosquitoes into a dark room. It makes foreign investors bring in money to earn the higher interest rate and this increases the competition for bills and tends to lower the rate to its previous level. Similarly, a fall in the market rate is a signal to foreign funds and even local money to fly away to other centres like moths to candles and the market must adjust itself to the scarcity of money as best it can.

The following are the usual quotations in the London discount market :—

Bank rate (changed from  $3\frac{1}{2}\%$  May 3, 1930)  $3\%$

Market rates of discount

60 days' bankers' drafts	..	..	$2\frac{7}{8}$ to $\frac{1}{2}\%$
3 months do. do.	..	..	$2\frac{9}{8}\%$
4 months do. do.	..	..	$2\frac{9}{8}$ to $\frac{3}{4}\%$
6 months do. do.	..	..	$2\frac{5}{8}$ to $\frac{3}{4}\%$
Discount Treasury Bills			
2 months	..	..	$2$ to $2\frac{1}{4}\%$
3 months	..	..	$2$ to $3\%$
Loans—day to day	..	..	$2\frac{7}{8}\%$
—short	..	..	$2\frac{1}{2}\%$
Deposit allowances : Bank	..	..	$1\%$
Discount houses at call	..	..	$1\%$
„ „ at notice	..	..	$1\frac{1}{4}\%$

The market has three sets of rates for 90 days bills. One is the Treasury Bills rate which is also applicable to bank acceptances and first class trade bills. The second is the rate applicable to acceptances of responsible private persons or firms and is very near bank rate, though it is more attached to the first rate, known as the market rate, by being about  $\frac{3}{4}\%$  above it. The third set applies to acceptances of less known parties and is half to one per cent. above bank rate according to the "rating" or standing of the party. This difference is due not only to the extra risk incurred but also to the fact that the Bank of England would probably reject them. As the same rate would be available from the banks, the market is not usually called upon to finance them.

Another set of rates applies to six months bills. These are  $\frac{1}{4}\%$  higher for bank bills than the market rate for three months bills, and  $\frac{3}{4}\%$  to  $1\%$  more for ordinary bills. The reason is that the three months rate is based on the expectation of bank rate remaining unaltered during the period, but the six months rate is a matter of far greater uncertainty and subject to influences which it is not possible to forecast or assess. Moreover, the Bank of England will not discount bills which have more than a fortnight to run and the minimum period for which the market will have to hold a bill would be 11 weeks for 90 days bills and 24 weeks for six months bills.

Sterling bills if not drawn on London may become

“domiciled” by being accepted as payable there by a foreign bank’s London correspondent or agent. The creation of domiciled bills is illustrated below :—

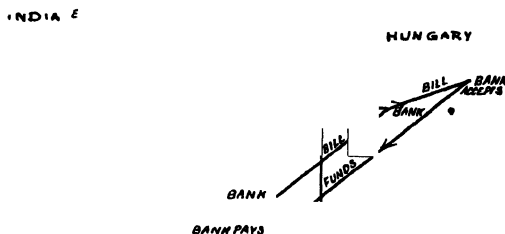


Diagram 13—The London domiciled bill.

Bills accepted by the London branches of foreign banks are classed with them by the discount market as not being eligible. These must, therefore, be kept in the banks’ portfolios though the market may take up to 10% of such bills in a parcel of bills but even then at  $\frac{1}{8}$  to  $\frac{3}{16}$  % more than the market rate. The reason why such bills are not acceptable is that the Bank of England will not rediscount bills with less than two British signatures, one of which must be that of the acceptor. It will be noted that the drawer may be a non-British person who is prepared to pay an acceptance commission to a London bank. The reason assigned for this moral discrimination is that the assets of the foreign acceptors would not be available as security for these bills. It is also explained that foreigners may thus create a volume of indebtedness in the London market and starve the local trade. They may also purposely create such bills for the sake of manipulating a financial crisis as in 1914 and in September 1931, when a moratorium had to be declared.

The London discount market is at the present time very keenly interested in the rates prevailing in New York because, in normal conditions, its rate must keep itself within short range either way of the New York rates. The following rates of New York are daily published in the London papers :—

### Current Prices in New York.

		March 25th 1931
Call Money	.. .. .	.. $1\frac{1}{2}$ %
Time money (90 days mixed collections)		.. 2 %

**Current Prices in New York—Contd.**

Bank acceptances, selling rates :—

* Members—eligible, 90 days .. ..	1½%
Non-members—eligible, 90 days .. ..	1½%
Ineligible .. ..	2%
Commercial acceptances, 90 days .. ..	2½%

The bank rates of other centres also have great interest for the London market because the bank rate in several countries is the lowest rate for loans or, in the eyes of the foreign investor, the highest rate at which he can possibly lend there. If he has agents there who would give him credit, it is also of interest to him as being the borrowing rate for funds there. The London market would, therefore, be able to know by watching these bank rates whether there was any chance of funds in London trying to move out or if there was further prospect of funds coming in. For example, a lowering of the Berlin rate would attract foreign funds from that centre to London and a raising of the rate would mean that London funds would be decoyed to Berlin. As the bank rates do not change very often, they assume importance only when a change is announced by any of the Central Banks. The financial journals publish the following rates weekly (along with some others) :—

**Current Bank Rates.**

	Changed	from %	to %
Amsterdam (Holland) ..	Jan. 24, 1931	3	2½
Athens (Greece) .. ..	Dec. 2, 1928	10	9
Berlin (Germany) .. ..	Oct. 9, 1930	4	5
Brussels (Belgium) .. ..	July 31, 1930	3	2½
Budapest (Hungary) .. ..	May 28, 1930	6	5½
Calcutta (India) .. ..	Jan. 15, 1931	6	7
Copenhagen (Denmark) ..	Nov. 12, 1930	4	3½
New York Federal Reserve	Dec. 23, 1930	2½	2
Oslo (Norway) .. ..	Nov. 7, 1930	4½	4
Paris (France) .. ..	Jan. 2, 1931	2½	2
Rome (Italy) .. ..	May, 20, 1930	6	5½
Stockholm (Sweden) .. ..	Feb. 5, 1931	3½	3
Swiss Bank .. ..	Jan. 22, 1931	2½	2
Tokio (Japan) .. ..	Oct. 6, 1930	5·48	5·11
Vienna (Austria) % .. ..	Sep. 9, 1930	5½	5

\* Member banks are share-holders of the Reserve Banks which will rediscount only genuine trade bills. Other bills are ineligible.

\* In Japan, interest rates are quoted in a very practical manner. For example, 5·48 per cent means 1·5 sen per day per yen 100 and 5·11 per cent means 1·4 sen per day per yen 100.

## THE DISCOUNT MARKET IN LONDON

It has often been said that the success of *the exchange banks in India in handling foreign trade bills is due to their access to the London market*. This is one of those half-truths which pass current and acquire authority by being quoted very often. It would, therefore, be valuable to discuss the claim in the interests of Indian banks desiring to enter the exchange field.

While they could not borrow in London on their own signatures, it does not mean that they cannot borrow at all. They could endorse paper which had already the signature of one British person as acceptor, and the discount house could add its own as the second if it had to rediscount it with the Bank of England. In fact, this is the basis of the popularity of the sterling bill in the international markets. Even direct borrowing is possible for banks of good standing like the Yokohama Specie Bank.

As regards non-British acceptances, the British banks themselves cannot place them on the market. They could borrow by having the other banks accept bills drawn by them and this would be equally open to Indian banks if they had sufficient standing. In any case, an Indian bank would have its own funds in London like the exchange banks and, as a last resort, it could borrow from the Bank of England. Moreover, a good proportion of our foreign bills are drawn on other centres and are not useful for discount purposes in London. As a matter of fact, the British banks cannot compete with the French, Dutch and Japanese banks in financing these bills.

The British banks have arrangements with some of the commercial houses in London to accept their bills drawn on them so that the houses can discount them in the market and obtain funds. From the purely banking point of view, there would be some hesitation in a bank taking up such a responsibility, but the business would not come so much to the exchange banks as to the London banks and the acceptance houses such as Kleinworts Bros. If Indian firms in London require such privileges, they would not be available even through the exchange banks and there would thus be little difference between a British exchange bank and an Indian exchange bank.

In order that Indian importers might get the advantage of the lower London rate on their imports, the foreign experts of the Central Banking Enquiry Committee suggested that the exchange banks in India should accept bills on their behalf instead of taking them for collection. This does not seem to take into account the facts of the situation. In the first place, most import bills into India are handled on D/P basis.\* It is not, therefore, possible that the banks would go out of the way to accept bills on behalf of persons for whom they do not recommend even outside parties to grant D/A terms. Secondly, if the bills continue to be D/P bills, the exchange banks could hardly accept them and place them on the London market as they would have to be brought to India for payment by the importers. Thirdly, it is not likely that the banks will do it for nothing and the net result for the importer might be no better than now. Lastly, the banks would insist on importers depositing adequate security for their accepting the bills and this would be rather a disadvantage than a benefit to the importers who would have to lock up in this way what funds they have.

## CHAPTER XXIII.

### IMPORT BILLS.

*"To greet the welcome guest"*

Types of bills—Bills under credits—Retiring bills—B.C. rates  
—Dishonoured bills—Exchange as per endorsement—Banks'  
guarantee—Bonded warehouses.

Import bills may be of two classes (a) with documents against acceptance, (b) with documents against payment, the former class being rare in India in contrast to the custom in other countries. They might also be classed as (1) bills against credits, (2) bills for collection.

In the case of a D/A bill, the draft is presented to the drawee and the documents handed to him after his accepting the draft. The bank keeps the draft locked up in its safe

\* Evidence of the Exchange Banks Association before the Central Banking Enquiry Committee.

after entering the due date in an Inward Bills diary. In other countries, we have seen that it would be placed on the discount market. A day or two prior to the due date, a notice is sent to the drawee calling on him to pay it.\* If the bill is in foreign currency he has to pay it at the bank's selling rate for that currency. In most cases, he would have made a contract for the rate of exchange and payment is made at this rate. Bill stamps are also collected from the drawee as also a commission charge of  $\frac{1}{4}\%$  on amounts less than £250 and  $\frac{1}{8}\%$  above that limit. This charge is often waived but, if the drawee insists on paying the bill by a draft of another bank, it will be invariably collected. Interest is added at 6% unless the bill is specially drawn as payable at a different rate. If the bill is in local currency, there can be no question of exchange.

The bill of exchange must be accepted within a day of presentation or the bill must be returned with a statement of the cause for non-acceptance. The custom in India is for the bank, in many cases, to send a note to the drawee to call and accept the draft, or pay for it if it is a sight draft. In this case it has to wait a reasonable time, sometimes about three days, for the drawee to call at the bank, because such a letter is not a presentation of the draft for legal purposes.

If acceptance is refused on presentation of the draft the bank has to protect the shipper not only by noting and protesting it if necessary, but also by clearing the goods on arrival, paying customs duty and Port Trust charges and taking delivery of them. As the original policy would expire in a few days after landing, a new policy of insurance should be taken out and the goods stored in the bank's or other godown. The forwarding bank or drawer should be notified of the dishonour and the local referee or "case in need" approached if one is mentioned or known to exist. If, within a reasonable time, instructions are not given to relieve the bank, it might have to sell the goods to reimburse itself after giving due notice to the parties concerned. If the goods are to be delivered to anyone else, the bank could claim prior payment of all its

\* The English law is that it is the debtor's business to seek his creditor and it may be held that the bank is not bound thus to give notice to the drawee, of the due date.



dues. So long as it has acted without negligence, it could have recourse against the drawer.

It often happens that importers, being in the interior, request that the documents be delivered to them in their town. Such bills are presented through one of the local banks, usually the Imperial Bank of India. There is also the Allahabad Bank which enjoys a good deal of this business and then there are the branches of the exchange banks themselves at such centres like Cawnpore, Amritsar, Delhi and Lahore. When the bills are due, payment is requested by the bank at the port at a rate of exchange which allows a margin of safety as the funds would only be received within a week of the day when the rate is quoted.

In the case of D/P bills, they are presented to the drawee for acceptance and both the drafts and documents are kept in the bank's custody. The usual practice is for the drawer to wait until the arrival of the goods, to pay for the documents and take delivery of them. Sometimes, he requests the bank to clear the goods and store them and he pays the duty and other charges. When he desires to retire the bill, he does so in the same manner as for D/A bills. Sometimes, he may neglect to do either and, as dock charges mount up very heavily after the first week after landing, it will be the business of the bank to clear the goods at its own expense to protect the interests of the shipper. When the goods are delivered, adjustment of these charges is made as in the case of D/A bills. If the drawee takes no action until the date of maturity of the bill, the bank must ask the forwarding bank for instructions.

Acceptance of a bill will enable the drawee to obtain control of the documents only if the bill so called for it. In other cases, it merely indicates the date up to which he can pay for the bill and receive the documents in exchange. The goods and the documents are the property of the drawer and the bank, and the former could countermand the instructions through his bank and ask that the documents be delivered to another party.\* The remedy for the drawee is against the

\* Q. 611. Questions on Banking Practice, London Institute of Bankers, 7th edition.

drawer for breach of contract and he has none against the holding bank. Of course, he is relieved, in such cases, from liability for the accepted draft.

It may happen that the bills are to be presented through another named bank and the receiving bank would insist on being paid the rupee amount at a rate of exchange to be settled by itself or make a flat charge which varies between one and three rupees and accept the other bank's draft on London.

If the bill is drawn under a credit, it may be received by a bank which is not the one which issued it. The bill would then have to be presented to that bank for being accepted by it or its client.\* The issuing bank will have to find out if the bill is for the whole amount of the credit or for part of it. In the latter case, the bill will be treated as an ordinary bill and the rate of exchange, if not previously agreed upon, will be the usual rate for bills. Interest will be at 6% as for other bills unless special agreement had been made at the time of issuing the credit. In the case of a final or only bill, adjustment will have to be made against any deposit from the client and interest allowed on it from the date of deposit till the date of the bill and for the balance at 6% till the date of the payment. In neither case would a commission charge be made, because the bank has already received a commission when opening the credit.

Payment of interest on drafts on India is generally at 6% as called for under the "Eastern Clause" from the date of draft until approximate date of return of proceeds to London, New York, etc. The drawee has the option of paying on the due date at the T. T. rate or at the D. D. rate which is  $\frac{1}{2}$  d. higher. But he would have to pay interest for about 15 days at 6% which is more than the difference in the rate. Some banks try to collect the cable charges but the clients rightly object to this, holding that the matter of T. T. or D. D. adjustment is one between the negotiating bank and the collecting bank. But, in the case of bills from Greece and the Levant, the drafts call for payment of cable charges by the drawee. It is, how-

\* In practice, import bills under credits are forwarded to the issuing bank in India.

ever, more to the advantage of the bank to have the bill paid by D. D., as it gains something more for the transit period. When payment has been made, a draft is sent to the forwarding bank if it is not a sister office, in which latter case a credit advice would be sent to London or New York, Yokohama or Paris etc.

This rate of 6% has no connection with the London or other bank rates, but it is related to the local price for money. Most loans in India are made at Imperial Bank of India rate with a minimum of 6% and sometimes at higher rates, and it is this rate which appears on the bills. In 1929 when the bank rate in London was 6½% it did happen that the clause was altered in several cases to read 7% but it is a fact that the holding banks were allowed discretion to collect at 6% if the drawees objected. It would also appear logical that, as the banks in India are financing these bills until payment, the interest charge should be the cost of money in India and, unless the Indian rates become lower, there would be no prospect of the Indian importers getting a better rate than 6% on these bills.

If the drawee does not settle the rate of exchange by a previous contract, the bill would be collected at the B. C. rate. This is the "Bills for Collection" rate and is settled every morning by the Managers of the exchange banks, and is usually  $\frac{1}{8}$  d. lower than the open rate expected for the day. Sometimes the latter might move one way or the other during the day but the B. C. rate would be unchanged. The B. C. rate will be quoted for T. T. and D. D., and the choice is at the option of the drawee.

Some importers put off making contracts almost until the last moment and make a contract on one day and take it up the next day. The advantage they gain is that the contract rate is generally the open market rate. Secondly, if a contract is made, the bank might waive the commission charge, while it would be invariably made in the case of B. C. bills. As we have seen, the prudent importer would have made his contract when ordering the goods, but imprudent importers are not very rare who consider themselves wise in taking advantage of the exchange movements when, perhaps, they have lost by waiting.

If a bill is dishonoured by non-payment and payment is enforced by law, according to the decisions on this subject, the holding bank is entitled to payment in local currency at a rate which would enable it to purchase the foreign currency amount, though the bank might claim that payment should be made at the rate ruling on the date when payment would have been made if the bill had not been dishonoured. This would not make much difference in ordinary circumstances but when the rate has been fluctuating widely as in 1920 when the rate moved from  $2/3\frac{1}{2}$  to  $1/5\frac{1}{2}$  or in 1923 when it moved from  $1/4$  to  $1/5\frac{1}{4}$ , the difference might be worth fighting about.

Some part of the imports into India is handled by the great commercial houses such as Ralli Brothers, E. D. Sassoon & Co., and these are financed in London. As soon as a shipment is sent forward, the covering documents are handed over to the London bank which accepts a bill drawn on it for the value of the documents. This bill is discounted in the London market and the documents are sent to India and they are paid for on presentation to the Indian office of the firm, though, sometimes, they are sent direct and the Indian branch remits at its own discretion. In some cases the bills are drawn on the Indian branches and are clean bills or bills with documents.

In pre-war days bills on India were occasionally made payable at "exchange as per endorsement", that is, at a rate noted on the bill. So long as the rate did not move very much this was not objected to but, in later days, there was very often a big change in the rates between the date of endorsement and the date of payment. Importers have, therefore, insisted that the exchange rate should be settled by them and this has not worked any hardship on any one as, the bill being drawn in sterling, the drawer gets his money, the holding bank gets its profits on exchange in India and the importer chooses his own time for fixing the rate. Consequently, the Eastern Clause is now almost universally inserted as explained earlier. Apart from this, it may be pointed out that 'exchange as per endorsement' does not give the holding bank any better title to settle the rate of exchange for the conversion of sterling into local currency than the Eastern Clause. If anything, the former gives rise to

prejudice against the bank as the rate is settled some weeks or even months before actual payment by an arbitrary assessment, whereas the Eastern Clause makes the rate subject to competition and negotiation in the importer's country. The phrase "exchange as per endorsement" has a meaning and value, however, if the bill is quoted in foreign currency and is bought by the local banker as he thereby secures the return of the sterling which he pays out. But this, in effect, makes it a sterling bill under the cloak of a foreign currency bill with the drawback that the drawee loses the chance of fixing the exchange.

The usual practice regarding import bills is to send them on by the fastest steamer out while the goods may have left by fast steamer or by freight. But it usually happens that the bills, having to be accompanied by documents, namely, the insurance policy and bills of lading, will not be ready for some days after the steamer carrying the goods has left the port. The bills would then have to be sent through the bank and would, therefore, catch only the next steamer out. In the case of shipments from Italy and the Levant, etc., the freight and mail steamers are the same and the shipments often arrive before the documents. When the goods are landed, the importer has five days in which to take delivery without payment of storage charges at the wharf and so he is anxious to take delivery as soon as possible. But the steamer agents will not give a delivery order on the port authorities except on production of a negotiable copy of the bill of lading, and the importer has to approach his bank with a request that it guarantee the production of the bill of lading in due course. The bank will, of course, see that the client is responsible or gives adequate security for giving the guarantee which has to be on paper stamped one rupee. When the documents are received, the importer hands over the bill of lading to his bank to release the guarantee to the steamer agents.

When goods arrive in port and are not cleared, the port charges mount up rapidly and if fairly prompt action is not taken the port authorities will sell the goods to pay for the dock charges. This is particularly vexatious in the case of

imports on account of mofussil clients as they have no means of finding out if their goods have arrived. In order to obviate this difficulty the United States have a system of bonded warehouses spread throughout the country at the chief centres of import, and goods intended for each centre are sent straight there under customs supervision and without previous payment of duty. On arrival at the internal centre the importer is duly notified and takes delivery of the goods just like importers in the port towns by paying railway freight, storage, duty and customs supervision charges on delivering the documents. The whole of the United States is thus able to do without the help of agents at port towns. A system of bonded warehouses in India would be of great advantage both in the port towns and in important up-country centres. This would relieve the congestion at the docks without penalising the importers too heavily as the goods could be sent there after the five free days.

1. A bill for £1,250 is to be retired at  $1/5\frac{1}{2}$ . Calculate the amount payable, with bill stamps and bank charges at  $\frac{1}{8}\%$ .

£1,250 at $1/5\frac{1}{2}$	..	..	..	=	Rs.	16,783	3	6
Plus bill stamps	..	..	..	=	Rs.	18	0	0
Plus bank charges at $\frac{1}{8}\%$	..	..	..	=	Rs.	20	13	11

The amount payable is .. .. = Rs. 16,822 1 5

Prepare a provisional memo. for a bill of £275-13-4 at  $1/5\frac{1}{2}$  including stamps and bank's collection charges, with interest from 10th March to 22nd May at 6%.

£275-13-4 at $1/5\frac{1}{2}$	..	..	..	=	Rs.	3,701	4	0
Add interest at 6% for 73 days = £3-6-2	..	..	..	=	Rs.	44	6	5
stamps	..	..	..	=	Rs.	4	8	0
bank charges at $\frac{1}{8}\%$	..	..	..	=	Rs.	4	10	0

Amount payable is .. .. = Rs. 3,754 12 5

3. A bill for \$784.65 dated New York 10th April is retired on the 15th June and interest at 6% is to be allowed also for the transit time of 25 days. Calculate the amount payable at 276 $\frac{1}{2}$ .

\$784.65 at 276 $\frac{1}{2}$	..	..	..	=	Rs.	2,169	8	10
Interest at 6% for 91 days	..	..	..	=	Rs.	32	7	2
Stamp charges	..	..	..	=	Rs.	2	4	0

Amount payable .. .. = Rs. 2,204 4 0

4. A bill for Yen 17,452.75 is retired at 134½ with bill stamps and interest for 73 days at 6%. What is the amount payable?

Yen 17,452.75 at 134½ .. .. = Rs. 23,473 15 3

Interest at 6% for 73 days = Y. 209.43 = Rs. 281 11 0

Bill stamps .. .. = Rs. 22 8 0

Amount payable is .. .. = Rs. 23,778 2 3

## CHAPTER XXIV

### FINANCE OF IMPORT BILLS.

*"My plighted word is enow, I trow"*

Trust receipt—Licensed warehouses—Rebate—Why short usance  
bills—Application to India.

When an importer desires to take delivery of goods before the due date of a D/P bill but has not enough money to pay for them, the bank often accommodates him by granting a loan under a trust receipt. He has to pay enough cash to meet the import duty and other charges and make a deposit of 25% of the amount of the draft. The goods are then handed over to him on his executing a deed of trust on the lines below.

17th May 1928.

To

The Exchange Bank Limited,  
CALCUTTA.

In consideration of your handing to us the shipping documents or goods as per particulars at foot, hypothecated to you as collateral security for the due payment of the undermentioned draft drawn upon us by Thos. Jones and accepted by us, we hereby engage to store and hold these goods as trustee for, and on behalf of, your bank, and the proceeds of sales of these goods shall be received by us as trustee for your bank and paid to you as and when received. At the same time, we promise to provide you with sufficient means by this or other methods, with funds to meet the drafts accepted by us, together with bank charges, commission and interest, at least three days before the date of maturity.

We also undertake to keep the goods fully insured against fire, burglary and other risks and to hand over to you all amounts received from the underwriters in case of such risk being realised, and we agree to hold the insurance policies as trustee for you and on your behalf.

Without prejudice to anything shown herein, we agree to return to you on your written demand at any time, the shipping documents or the goods and the insurance policies duly assigned to you.

(Sd.).

Amount of bill.	Due Date.	Particulars.	Description of goods.	Marks and Numbers.	Vessel.
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The bank expects him to hold the goods in trust for it and to keep them fully insured during the period of the loan and to pay in the proceeds of all sales to liquidate the loan and in general to do everything in his power to keep their value unimpaired as security for the bank. The rate of interest on these loans would be the same as for other loans with similar security, namely, Imperial Bank of India rate with minimum 6%, or 1% above it with minimum 7%. Though this makes the cost more to the importer, he obtains possession of the goods.

The trust receipt is also taken by banks when they wish to have some additional security even when documents are handed over against acceptance.

"The custom of delivering goods under trust receipt seems to have originated in America, where the law recognises to a far greater extent than elsewhere the bank's property in the goods after they are given up to the acceptor of a bill. As a matter of fact, the drawer of a bill from this side will rarely authorise delivery under trust receipt and the banks abroad, more often than not, take the responsibility themselves, which means, in effect, that they part with the goods contrary to the instructions of the drawer, to whom they are then, of course, responsible for the ultimate payment of the bill representing the value of the shipment. The whole thing in principle amounts to this: the difference between a five pound note in your pocket and another man's owing it to you; and although the system is good enough where the acceptor is perfectly trustworthy, yet, so long as human nature is what it is, difficulties will always arise, and from the standpoint of British banking we have no hesitation in saying that trust receipt facilities are open to grave objection." (W. F. Spalding, *Foreign Exchanges and Foreign Trade*.)

We may remark that the Exchange Banks Association wished the Central Banking Enquiry Committee to suggest that frauds under trust receipts should be made a criminal offence, but the committee did not make a specific recommendation. The alternative system of storing in the bank's godowns is subject



to two disadvantages. The client could obtain partial deliveries against payment of what he states to be the relative value and the bank might find that its security is considerably depreciated owing to the better class of goods being sold, and its being left with goods of comparatively little value. In the case of piece-goods etc. of uniform value, partial delivery may be permissible and even beneficial, but, in other cases, the system is not without its defect. Secondly, the importer would have to resort to the bank every time he wants to sell the goods or show samples to possible buyers, and his prestige with his clients must suffer.

A system of public warehouses will get over this difficulty as the clients will not necessarily know on whose account the goods are stored and, in this respect, it is to be hoped that the licensed warehouse system will be popularised and recommended by the Central Banking Enquiry Committee. Even now there are a few such warehouses in Bombay. But they are not licensed and the trust of the banks in the owners of these warehouses has been built up through long connection. Men like Mr. Tulsidas Khimji are entrusted by the banks with several lakhs worth of their property because the banks know that they are men of sterling worth and responsibility. A licensed warehouse will enable the banks to place the same kind of trust in it and enable them to keep control over the goods without loss of dignity to the importer. While the dangers incidental to partial delivery will still persist, this is much better than handing over all control of the goods to him and depending upon his good faith to the extent of 100%.

Import bills are generally drawn under *c. i. f.* contracts, that is, to include cost, insurance and freight. The importer will pay in addition to the agreed price only the interest, stamps and bank charges. In some cases the quotations are *c. i. f. & c. i.*, that is, they also include commission and interest. The commission may be one due to the selling agent in the foreign country, of goods manufactured by large factories, or it may be the charges of the banks for handling the bills, interest being included in the price at which the goods are to be bought. It may happen that the importer finds it advantageous to retire the bill before the due date and in this case he is

entitled to an allowance for previous payment. This allowance is called the "rebate". Though interest is usually charged on bills on India at 6% and this would naturally have been included in the *c. i. f.* and *c. i.*, price, rebate will not be allowed by the banks at that rate but it is a matter for negotiation between the bank and the importer. In general, rebate is allowed only at 2%, but, sometimes, it is a matter of higgling, and 3 to 4% may be allowed during periods of tight money. Of course, the importer has the option of postponing the payment ; but if the bill is drawn D/P, he cannot obtain control of the goods unless he pays for it and it becomes a question of which is more profitable for him.

When a foreign office of an exchange bank buys sterling bills payable in India with the Eastern Clause, it has two options. It may take the bill as part of its own operations and claim credit for all the profits arising out of it except the exchange and commission charges in India. When the bill is paid the proceeds will have to be remitted by the branch in India to the London branch with the request that they may be credited to the account of the remitting office as of the date of payment or as of the date of receipt of advice. In either case, the interest up to the date of credit should be added to the face value of the bill collected. The second alternative is to have the bills treated as bought on behalf of the Indian office, as of the date of purchase. In this case no profits arising out of the interest charge will accrue to the foreign office.

In the case of bills on India with or without the Eastern Clause, under credits or otherwise, banks do not like bills with long periods of usance. It may be argued that as they get 6% on their money during their tenor, it is quite a sound investment. In fact a domestic bank would jump at such a safe investment at so good a rate. But this does not take into account the essential difference between domestic banking and exchange banking. From the statement of the profits of the exchange banks in Chap. XVII, it will be seen that, by using about ten crores in purchasing outward bills, they make a profit of about 75 lakhs, while, by using about 50 crores in domestic business, they make only about 90 lakhs. The reason is the

quick turnover of the funds in the foreign exchange business. An export bill has to be financed only three weeks by the banks before it is disposed of in the London or other markets and funds can be turned over about 17 times a year. The greater the volume of business handled, the greater will be the profits obtained at  $\frac{1}{16}$ d. per rupee. Exchange banking, indeed, is a case of quick returns and large profits.

Looked at from another aspect, if a bill is of long usance, say six months, and is sent to India for collection, the holding bank will have to wait all that period before it receives payment, as there is no discount market here. This means that the money can be turned over only twice during a year instead of seventeen times in the case of London bills. The extra interest earnings do not, therefore, constitute a real benefit to the exchange bank.

We can also look at the question from another point of view. The average exports and imports from India handled through banks total about four crores each per week. The first week's remittance to London will be cashed there in three weeks. If we suppose that a bank starts operations in London and Bombay at the same time, the London office will have to find funds for financing three weeks' import bills on India when it will have the proceeds of the first batch of bills remitted from India to purchase bills for the next week. It will therefore require only 12 crores of rupees or £9 millions for the purpose. On the other hand, the Bombay office will have to pay out rupees in buying export bills until the first batch of bills from London are paid. Assuming that the average usance is 75 days, and importers take up bills on an average in six weeks, the Bombay office will have to wait three weeks of transit time and six weeks after arrival of the bills in India, or nine weeks on the whole, before it will get new funds from them. This means that it will require about 36 crores of Indian funds. In fact, this should be the amount advanced by the exchange banks to the drawees to take up their bills. This is proved to be so from the statement furnished by the exchange banks to the Central Banking Enquiry Committee. Out of the total advances of all the foreign banks in India of 46 crores, the export trade would not require more than two weeks accom-

modation or ten crores from the exchange banks for shipments waiting at the ports and the balance of about 36 crores should, therefore, represent the advances to importers, or the volume really locked up in inward bills. Further, the advances to Europeans who are chiefly exporters amount to 15 crores, while advances to Indians who are mostly importers amount to 31 crores.

If, therefore, bills of six months usance were bought by the London office, it is probable that they will not be paid before five months on an average. This means that the Bombay office will have to wait 24 weeks before it gets funds from the payment of the first batch of import bills. In other words, advances to importers will have to be about 100 crores and the exchange banks will have to get as deposits more than this amount. With about 65 crores of deposits they are able to lend only about 36 crores to importers and, on this basis, the foreign banks would require between 150 and 200 crores of Indian deposits. When it is remembered that the total deposits of all banks in India is only about 210 crores, and that more than 70 crores of them is in inland centres, it will be seen that the exchange banks cannot carry on their business under present monetary conditions in India if bills of six months usance were made the rule.

1. A bill for £1,250 is retired under rebate at 2% for 16 days at  $1/5\frac{1}{4}$ . Find the amount payable allowing for bill stamps.

£1,250 at $1/5\frac{1}{4}$	..	..	..	=	Rs. 16,783	3	5
Less interest for 16 days at 2%	..	..	..	=	Rs.	14	11 5

					Rs. 16,768	8	0
Plus bill stamps	..	..	..	=	Rs.	18	0 0

Amount payable	..	..	..	=	Rs. 16,786	8	0
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2. A bill for Marks 17,850·20 is retired at  $151\frac{1}{4}$  with bill stamps and bank charges and rebate at  $2\frac{1}{2}\%$  for 23 days. Find the amount payable.

RM. 17,850·20 at $151\frac{1}{4}$	..	..	..	=	Rs. 11,801	13	10
Bill stamps	..	..	..	=	Rs.	13	8 0
Bank charges	..	..	..	=	Rs.	14	12 2

					Rs. 11,830	2	0
Less rebate at $2\frac{1}{2}\%$ for 23 days	..	..	..	=	Rs.	18	9 6

Amount payable	..	..	..	=	Rs. 11,811	8	6
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3. A bill for kroner 23,472·75 is retired in London at 19·20 with stamps and rebate at  $1\frac{3}{4}\%$  for 32 days. Find the amount payable.

Kr. 23,472·75 at 19·20 .. ..	=	£1,222 10 10
Less interest for 32 days at $1\frac{3}{4}\%$ ..	=	£ 1 17 6

		£1,220 13 4
Bill stamps at 1/- per £100 .. ..	=	£ 0 13 0

Amount payable .. ..	=	£1,221 6 4
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## CHAPTER XXV

### A DISCOUNT MARKET FOR INDIA.

*"Meseems it were a noble thought"*

Discount market and foreign bills—And import bills—And exports in port towns—Import bills of small size—And drawn D/P—Funds required for the discount market.

It is usually thought that the discount market is the concern of those responsible for organising the money market and the question has been treated accordingly. But we have seen that the discount market in London is even more important in connection with its influence on foreign trade and the exchanges than on the internal trade. The London discount rate for 3 months and 6 months' bills is of great importance to most countries and, specially to India, because the rate at which our sterling bills will be bought in India depends on this rate. International interest in India may never be so great as to attract foreign funds in the same way as to other centres, but as we have a well organised forward market it is quite possible that if a discount market is in being, it will create a good volume of bank acceptances which would be a temptation for foreign money to enter and leave India according to the exigencies of world monetary conditions. How bank acceptances can be popularised will be discussed in a later chapter.

The importance of the foreign trade in the transactions of the discount market is best illustrated in the case of New York. In the year 1926, at the end of December, there were

outstanding \$755,000,000 the distribution of which was as follows :—

Imports	...	...	\$ 283,000,000
Exports	...	...	\$ 261,000,000
Domestic warehoused goods	...	...	\$ 116,000,000
Storage or in transit abroad	...	...	\$ 40,000,000
Domestic shipments	...	...	\$ 29,000,000
Finance bills	...	...	\$ 26,000,000
Total bills outstanding	...	...	\$ 755,000,000*

It will be seen that only \$145,000,000 was for domestic purposes and that more than 82% was for foreign trade. It would seem, therefore, that a discount market can thrive very well on foreign trade alone. Though, of course, our export trade would not give rise to acceptances as in New York, there will still be enough for the market from the other types of business connected with the foreign trade. In Japan, the total of foreign bills in the market has been increasing steadily and at one time was estimated ¥400,000,000.†

The popularity of a rupee bill or its usefulness in financing foreign trade to some extent must depend on the proper organization and efficient working of a rupee discount market. But so long as there is no discount market in India, so long will import bills continue to be drawn in sterling and continue to be kept in the safes of the foreign exchange banks and so long will they themselves require a considerable volume of Indian deposits to finance these bills. If there were in existence a discount market it will no longer be necessary for the foreign banks to hold the bills in their portfolios.

Looked at from another point of view, the bills would be of great assistance in creating a discount market. At the present time the complaint is that trade bills as such rarely appear on the market. Most bills that are created are accommodation paper or finance bills and though there is probably a big volume of hundies circulating in the country there are no means of determining whether they are self-liquidating and based on commercial transactions or are merely drawn for the sake of raising money. The latter class are not suitable

\* Randolph Burgess, *The Reserve Banks and the Money Market*.

† J. Inouye, *Problems of the Japanese Exchange*, 1914-26.

for a discount market and the volume of the former class is not known.

The question has been raised whether the import bills will be of any use to a discount market because they are in very small amounts and on parties whose credit is not very high. This is certainly a serious objection. But it must be remembered that the foreign banks who have complained before the Central Banking Enquiry Committee of the great difficulty they have in ascertaining the standing of the parties, find it possible, at present, to lend these people substantial amounts and even release the goods on trust receipts, in some cases. Surely, the Indian discount houses with the greater facilities which they will have of obtaining reliable information regarding the importers should have no difficulty in choosing the proper type of bills. Secondly, if the import trade of India of about 250 crores consists of small bills, then the discount market has to organise itself to take them up as it will lose all that amount of business if it does not. Banking in India has adjusted itself to modern needs and the discount market should have no difficulty in this direction. Thirdly, it has not been suggested by any one that, as a class, importers are less reliable than others and, though the men may be of small means and the bills of small size, the integrity of the drawees is undoubted and the exchange banks have not suffered through giving them credit, nor have any bills failed to be duly honoured at maturity. The discount market could, therefore, with equal safety deal with them.

Another objection is that the majority of bills on India are D/P and that they would be of no value to a discount market. This is a more serious objection. But where there is a will, there is a way, and some suggestions are made in a later chapter as to how these bills could be converted into D/A bills through the co-operation of the exchange banks or of local banks if the former will not help.

It may be that when the money market has succeeded in attracting enough resources for its operations, the authorities may consider the feasibility of financing some part of the export trade in India through rupee bills or Indian funds, but this

must, of course, depend on the efficiency with which the discount market works. But speculation on this matter at this stage will be like "the young couple who quarrelled on the wedding night as to the name of the baby that will be."

If all import bills could be put on the market as soon as they are accepted there would be at least 200 crores of such bills per annum, providing an average of 4 crores per week ; and, assuming the life of each bill to be about 6 weeks, we should have about 25 crores of money locked up in this class of business. These bills would also be very valuable to the Reserve Bank in supplying the increased seasonal demand for currency in the country.

The export business would also give rise to acceptance bills during the time between the purchase of the goods and their actual shipment. The volume of such borrowings at the present time is not known. But an estimate can be obtained from the fact that, out of the total of 200 crores worth of goods moving through bills, or four crores per week, there would be about 25 crores of money locked up, on the basis of an average of 6 weeks waiting. Out of this about 10 crores will be found from the owners themselves and from other sources and 15 crores probably obtained from the banks. This amount could be supplied by the discount market.

The question, therefore, is whether the discount market can find 40 crores of money for its operations. So far as internal bills are concerned, we do not take them into consideration for the moment. It can be expected that about 10 crores would be available from the Reserve Bank through rediscount facilities. The contribution of the banks as call money would be about five crores. There would then be required about 25 crores of money from the discount houses themselves. The deposits released from the exchange banks as a result of the operations of the discount market would be about 40 crores and, of this, it is not unreasonable to expect 25 crores to go into the discount market. Of course the scheme can only be worked out by stages. The discount houses will be started with some new capital on the reliance of the Reserve Bank and its facilities. This will help to take off some of the



import bills from the hands of the exchange banks and they will have to release some of their deposits as they will not find use for them. Some of these deposits would go to the discount market either as new capital or as deposits and this would, in turn, take off some more bills from the hands of the banks. The process will certainly take time, say about five to ten years, but it has to be done some time or other and the sooner, the better.

In other countries, the insurance companies invest a good proportion of funds in bills. For example, in London they hold more than £50 millions of bank acceptances out of a total of £400 millions. The same conditions might obtain later on in India also, particularly as the companies in India have about 40 crores of funds some of which they have difficulty in safely investing and the amount is growing every year.

## CHAPTER XXVI.

### LETTERS OF CREDIT.\*

*"Faith can move a mountain."*

Traveller's Letter of Credit—Traveller's Cheques—Documentary Credits—Revocable—Liability of issuing bank—Value to exporter—Irrevocable—Confirmed—Clean—Acceptance Credits—Credits in India—Examples of Credits.

Letters of Credit may be classified into two main divisions, the first being the 'Travellers' Letters of Credit and the other the Commercial Letters of Credit. The latter are intended to help in the movement of goods and the former are intended to supply the traveller with a safe form for carrying his funds, so that he runs little risk of losing them, and can obtain any supply during banking hours. These Letters of Credit are addressed to the issuing bank's correspondents abroad, a list of whom is attached, and authorise them to cash drafts drawn against them, indicating on the drafts the number of the Letter of Credit and the date of issue. They are issued generally for a period of one year, after which time any

\* Part of the chapter and the next is based on notes of a lecture before the Sydenham College of Commerce Banking Association in 1925, delivered by the author.

balance is payable to the holder only through the issuing bank or by the issue of another Letter of Credit at his request. The issuing bank usually receives beforehand the face value of the credit and a commission  $\frac{1}{2}$  to 1%.

In order to obviate the possibility of the holder of the Letter of Credit drawing too many drafts against it, and thus defrauding those who negotiate them, the negotiating bank is requested to write in the place allotted for it, its own name, the amount of the draft and the date of purchase. Thus, anyone inspecting the Letter of Credit can know exactly how much still remains to be drawn. If a draft is finally drawn to complete the amount of the Letter of Credit the person negotiating it takes charge of the Letter also and forwards it to the issuing bank. In a recent case, a holder fraudulently raised the amount of a Letter of Credit from £100 to £1000 and drew all of it before the fraud was discovered. One of the parties cheated was an international concern and it spent several times the amount of its loss to bring the man to justice though it had to pursue him through four continents and over 75,000 miles and had to get him extradited under the international treaties from his hiding place in the Andes mountains in a South American Republic.

The holder of the Letter of Credit has to satisfactorily identify himself so that there may be no question of genuineness of the drafts drawn. This he may do by exhibiting a passport or by getting himself introduced by local men known to the bank. The issuing bank also helps by obtaining a specimen signature of the holder either on the Letter of Credit itself or in a separate Letter of Indication. After fully satisfying itself regarding details, the negotiating bank would pay him the equivalent in local currency at the rate of buying demand drafts on the centre indicated by the currency of the Letter of Credit, London for sterling, New York for dollars, Paris for francs etc. The great safety of the Letter of Credit lies in its being non-negotiable though drafts under it are negotiable. Hence, a loser can easily get his money back from the bank by executing an indemnity bond.

When a letter of Credit is presented to a bank for cashing

a draft against it; caution should be exercised in regard to several details. These are symbolised in the word "PUISSANCE"—an idea suggested by an article in the Journal of the London Institute of Bankers :—

- P Passport for identification?
- U Under authorised amount?
- I Indorsement of amount in Letter of Credit?
- S Signature of issuing bank?
- S Signature of beneficiary?
- A According to terms of credit?
- N Number of credit (shown in draft)?
- C Cancelled or countermanded?
- I Expired or alive?

A special type of this Letter of Credit is what is popularly known as 'Travellers' Cheques or Circular Notes. These are issued in fixed denominations but can only be cashed as a whole. Thus, if a Cheque is for Ten Pounds, it would have to be cashed for the whole amount, whereas, in the case of a Letter of Credit, the draft could be drawn for any amount and any number of drafts could be drawn. These Cheques are usually issued against cash and a commission of  $\frac{1}{2}\%$  to  $\frac{3}{4}\%$  is charged. They were first issued by the American Express Company about 1840 and have now been copied in most countries and by most banks. The business in India is mainly in the hands of Thos. Cook & Son.

'Travellers' Cheques are so popular in the United States that the American Express Company alone, has several million dollars worth of them outstanding at any time. This means that it has borrowed so much money from the public for nothing and has so much to invest at a profit. To all intents and purposes these Cheques are the equivalent of currency notes in their own countries and regarded as such by people who willingly pay the commission charge of  $\frac{1}{2}$  to  $\frac{3}{4}\%$  to the issuing bank for the sake of the advantage that if the cheques are lost or stolen, the money will be refunded to the purchaser on his furnishing a suitable indemnity bond. The thief cannot obtain any money on them because he will have to forge the signature of the purchaser which is shown on the cheques.

It is a tribute to the efficiency of the bank's protection that even the most expert of international crooks have refrained from attempting to forge the signatures on lost or stolen Travellers Cheques.

Letters of Credit are issued in any currency as desired by the purchaser but on account of their international value, sterling or dollars are used commonly. In England, sterling is payable pound for pound and in the United States, dollar for dollar is paid against Dollar Letters of Credit. In other countries they will be treated as sight drafts on London or New York and cashed at the corresponding rates.

A Letter of Credit may be of the "revolving" type when it would be further classed under three types:—(1) where the stipulation is that outstanding drafts at any time should not exceed the face value of the Letter of Credit (2) where the amount should be drawn as one bill and is available again when advice is received that the previous bill has been paid (3) where it allows drafts not exceeding the face amount to be drawn within a certain period, say one month or one year, and becomes renewed for a fresh period for the full amount. In practice, types one and two are rather uncommon as they are impossible to control from either end. The one most commonly in use is the third type. This may again be cumulative, if the unexpired balance of any period can be drawn in a later period and non-cumulative if the Letter of Credit begins afresh at the end of each period.

**Commercial Letters of Credit** are intended to facilitate the movement of goods and they may be looked at from two points of view, whether they are intended to move imports to the country or move exports out of it. A somewhat nice distinction is drawn by some authorities between a commercial credit and a commercial Letter of Credit. The former means that the credit is a single authority which must be availed of in one shipment. The latter means that it is like the Travellers' Letter of Credit and the exporter can make partial shipments and avail himself of the credit in several drafts. Partial shipments would not, however, be allowed unless the commodity purchased was a homogeneous one, and negotiating

banks could determine whether the face value of the drafts corresponded, roughly, to the amount of goods shipped. Examples of various credits are given at the end of the chapter.

Commercial credits might be "clean" or "documentary". In the former case there need be no evidence on the face of the bills that they cover movements of goods, and, in fact, they may not represent such movements. These credits are granted only to very responsible parties. In the case of documentary credits, documents covering the goods are to be attached to the bill at the time of presentation to the drawee and, therefore, all parties taking this type of bill have the security of the goods concerned. Mr. Spalding refers in his books to the custom of some "Eastern" bankers to restrict the term "documentary" to those credits of the revocable type in which bills are to be accepted by the importer and not his bank. It would appear that "Eastern" bankers should correct this mistake as this term is used in the other sense in all other countries. The American authors and code books refer to documentary credits as those for which documents have to accompany the bills and they also refer to revocable documentary credits and irrevocable documentary credits, which would be a contradiction in terms if the 'Eastern' bankers were right. Even English writers are not in agreement with them. Mr. S. E. Thomas in his "Principles and Arithmetic of Foreign Exchange" (pp. 404-5) writes :—

"All credits which cannot be classified as clean or blank are described as documentary, implying that the issuing banker agrees to accept drafts *drawn upon him* only if they are accompanied by specified title to goods or other form of collateral security. Some writers seek to distinguish a documentary credit as being of an entirely special type, but the description is correctly applied to any credit, revocable or irrevocable, confirmed or unconfirmed, fixed or revolving, which calls for delivery of documents by the beneficiary."

Documentary credits might be either open or restricted to one bank. They may also be revocable or irrevocable credits. They may be fixed or revolving as in the case of the 'Travellers' Letter of Credit. They may call for drafts to be drawn on the real importer or they may permit them to be drawn on the issuing bank or its office or agent in another

centre. In any case, there is the bank's guarantee that, on presentation, they would be duly honoured by acceptance and payment in due course. Bills under the former type of credit are known as commercial bills and bills under the latter type are called banker's bills. Except that the issuing bank shifts the ostensible burden of acceptance and payment to the importer it gains no advantage by making the latter accept them. On the other hand, they command a lower price than bank bills, being liable to discount at bank rate and not market rate. Sometimes, the credits only permit the exporter to draw for a portion of the invoice value and the balance is to be remitted by the importer after satisfying himself that the shipment has been made in accordance with the selling contract.

The credit might be a simple 'authority to negotiate' drafts drawn by the exporter and presented to the bank advising him of the authority. The exporter has to get his documents ready and present them to that bank, which would pay him rupees at its own rate for buying that type of bills. But, if he is dissatisfied with the rate quoted, he cannot try other banks as they are not authorised to buy the bills. Below are diagrams showing the working of such credits :—

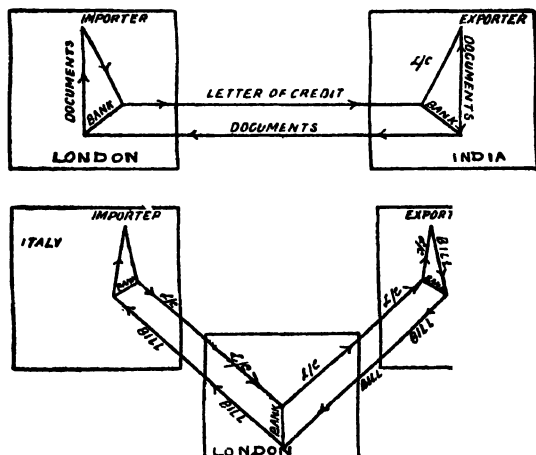


Diagram 14. The London 'authority to negotiate'.

Diagram 15. The foreign sterling 'authority to negotiate'.

The credit might be an open one but available in India through a named bank, in which case also no other bank will buy the drafts, as they would have to be presented to the named local bank which would pay in rupees at the same rate or even worse. The credit thus becomes a kind of restricted credit.

The credit may call for presentation of the documents in the foreign centre for acceptance. In this case it would be open to any local bank to negotiate the bills and send them on to that centre and treat the transaction as a purchase of foreign exchange. The exporter has then the choice of several banks to whom he might try to sell his bills. If his bills will not be ready for some time, he could make forward contracts and protect himself against exchange risks. The working of the open credit is illustrated below :—

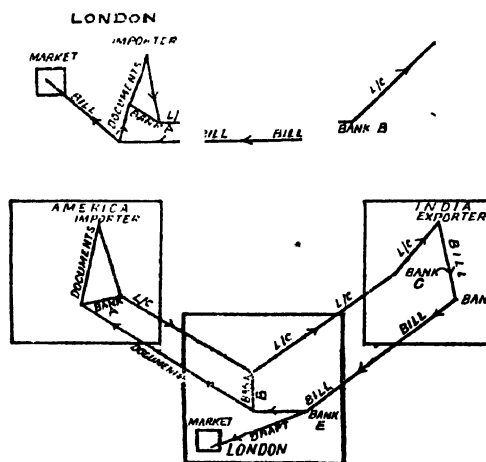


Diagram 16. The London open credit.

Diagram 17. The foreign open sterling credit.

Some writers and bankers have tried to make out a distinction between confirmed and irrevocable and between unconfirmed and revocable. The words confirmed and unconfirmed were loosely used in Europe and the other set of words in America. The International Chamber of Commerce after hearing both parties decided that—(1) A revocable credit was one which could be cancelled by the importer ; (2) An

irrevocable credit was one which could not be so cancelled ;  
(3) A confirmed credit is one where a local bank advised the beneficiary of the genuineness of the issuing bank and the signatures on the credit.\* As most of the important commercial nations are members of the International Chamber, it is to be hoped that the suggestions will be universally adopted.

A bank negotiating a draft under a revocable credit without notice of the cancellation is entitled to acceptance and payment of the draft. Therefore, when a bank revokes a credit it has to provide for drafts already negotiated and on the way, and should arrange with the client accordingly. Even if the revocation is on the way, drafts negotiated before the receipt of the notice by the beneficiary are protected. If the beneficiary suppresses the notice and negotiates the drafts, he could be sued for breach of faith and recovery of the amounts paid against such drafts. There is thus a contract on the part of the issuing bank with third parties to honour bills, but with the exporter the contract is valid only until he receives notice of revocation. Just as an offer of a contract is not revoked by posting the cancellation, the exporter is entitled to negotiate drafts under the revocable credit even while the revocation is on the way. The decision in *Stein v. Hambros Bank of Northern Commerce* supports this view. The Court declared that the "obligation of the bank was absolute that when the documents were presented they had to accept the bill ; that was the commercial meaning of it."

It is claimed that, though the issuing bank may thus have to accept bills negotiated by other banks, it has a right of recourse against the drawer for the liability created after the credit had been revoked, that this revocation operates from the day on which the issuing bank decided to do so and that a revocable credit, by its very nature, put the exporter on guard, and it was not necessary for the bank to give him notice of cancellation. It would seem that this argument is not sound, for banks in practice do send notice of cancellation to the beneficiaries, a procedure which would be unnecessary if such notice

\* Bulletin—Uniform Regulations for Commercial Documentary Credits.



was not legally required. Mr. Spalding in his "Foreign Exchange and Foreign Bills" says :—

"The case of the exporter or manufacturer who has acted on the strength of the advice of the issue of the credit seems to be on a different plane and there is reason to suppose that if ever cancellation forms a cause for legal action the position will be that unconfirmed credits are only subject to revocation to the extent that they shall not have been acted upon when notice of revocation or cancellation is received by the exporter or whoever the user may be."

Mr. S. E. Thomas writes in his "Principles and Arithmetic of Foreign Exchange" :—

"Some bankers consider that a credit of this kind may be cancelled *at any time*, whether it has been acted upon or not; but the better opinion undoubtedly is that such a credit may be cancelled only to the extent that it has not been acted upon by the foreign beneficiary when he receives notice of the cancellation or revocation."

It will be seen, therefore, that, in reality, the negotiating bank depends as much on the issuing bank as on the recourse it has against the exporter as drawer of the bill and if it became necessary to file a suit, it would naturally do it against the bank as being the easiest way of realising its dues. The exporters have tried to protect themselves against the possibility of being sued, by asking for credits under which bills may be drawn "*sans recours*" but this, in fact, makes them irrevocable credits and such credits are not issued.

It may be asked why exporters accept credits of this doubtful value. The first reason is that bills under these credits are better than ordinary bills as banks will readily buy them. With a trade bill, its marketability depends upon the credit standing of the drawer and the drawee and the value of the goods etc. But bills under credits, even revocable, have the issuing bank's guarantee behind them and are sought after. Secondly, the importer may not issue a better type of credit and the option is one of "take it or leave it." And an exporter *must* sell his goods and he has to make the best of the situation. Thirdly, he knows that, so long as he is able to negotiate the bills before the revocation comes, he is safe and the risk is only with regard to goods he has bought or manufactured on the strength of the credit but which he is unable to ship. This

is, however, an ordinary trade risk. Lastly, the exporter knows that he has not to worry about the standing of the importer and that he is dealing with a bank with a reputation to lose.

If the credit is an irrevocable one, the issuing bank unconditionally offers that all bills drawn under it will be duly honoured by it if drawn according to its terms and if accompanied by the specified documents. The acceptance of the bills may be by the importer, but is more usually by the bank itself or its foreign agent. The irrevocable credit is, therefore, the safest one for the exporter and for this reason it is not ordinarily issued. For example, if partial shipments are allowed, the importer could, if he is dissatisfied, cancel a revocable credit, by wire if necessary, and prevent the completion of the contract. If the credit were irrevocable, he would have no such remedy and his relief would lie in resort to a court of law for damages ; but this means delay, expense and, in some cases, prohibitively high legal costs in foreign countries. Irrevocable credits do not always show a time limit within which they should be availed of. This is not important in the case of a revocable credit as the exporter would be anxious to utilise it lest it should be cancelled. In the case of an irrevocable one he might "sit on it". The International Chamber of Commerce has therefore suggested that an expiry date should always be given.\*

When an importer desires to issue a credit in favour of a foreign exporter, he approaches his bank and requests it to open the credit through its office or correspondent at that place and generally he has to make a deposit between 5 and 25% to cover fluctuations in the price of the goods and the possibility of losses if the drafts under the credit are not duly met or paid. He will have to make an application in a specified form like the one at the end of the chapter.

In some special cases the credits may be "clean" ones. The security for the issuing bank is only the reliability of the importer and any valuables pledged by him the current account which he maintains with the bank. It is only given to parties with whom the bank has had long connection and whom it has

\* Bulletin—Uniform Regulations for Commercial Documentary Credits.

learnt to trust. As soon as the beneficiary has sent the goods he sends the documents direct to the importer and draws a draft which he negotiates with a bank. Sometimes the credit could be used for speculative purposes. Thus, in Bombay, recently, a cotton firm obtained clean credits with several banks to cover shipments sent to its Antwerp office. It was found that the Antwerp agent had defalcated for some months previously and there was no tangible security behind the drafts which were outstanding except the credit of the drawer and that had been smashed by the Antwerp loss. It was realised too late that the banks in Bombay had thus been "*cleaned*" of about 15 lakhs by issuing these *clean* credits.

The credit may be what is called a "London acceptance credit". Many of the big exporting firms in London have made arrangements with the banks under which they draw bills on them against their exports, in some cases, accompanied by the corresponding documents, but sometimes without. The banks accept the bills and send the documents to their foreign agents to collect. The exporting firms discount the bills on the market and reimburse themselves. It is the business of the exporting firms to find the money to meet the bill at maturity. This procedure is also followed by some foreign banks who send the documents out to their own correspondents for collection but draw bills on the London banks to finance their exporters for the period.

The difference between such bills and bills under ordinary credits or even documentary bills is that the benefit of the exchange on the return of proceeds to London is not available for the accepting banks, and even if the documents are in the hands of the bank, the importer might well give a London draft in settlement, and the profit on the exchange may go to some other bank. Sometimes this difficulty is got over by drawing the bills in duplicate, the original being discounted in the London market and the duplicate sent abroad for collection with exchange to be sold through the holding banks. This practice prevails in centres like Japan and the United States.

The charge for issuing these credits is between  $\frac{1}{2}\%$  to  $1\frac{1}{2}\%$  varying in accordance with the terms of the credit, is lower

for those where the bills will be accepted by the importer, lower for revocable credits, and highest for confirmed bank credits. The charge would depend on the country from which the export comes as also on that of the importer and the particular commodity to be financed. In view of the risk assumed<sup>a</sup> by the issuing bank the compensation seems ridiculously low. But it must be remembered that the issuing bank merely gives its credit as implied by the term and does not put up any money. The "credit" of the bank is an insurance of the bill<sup>ts</sup> and the commission charge is an insurance premium.

In practice, bills on India are drawn in sterling as also bills by India and, whoever the issuing bank is, the acceptance is usually by a London bank. The reason is that London is ordinarily the cheapest discount market. This means that foreign banks have to make arrangements with some British banks to accept their bills. There is an additional advantage in this that the credit of the foreign bank is considerably enhanced by the association with the big London banks. The British banks make an acceptance charge of  $\frac{1}{2}\%$  to  $\frac{1}{10}\%$  per cent per annum and the volume of this business is large, for the handling of which a commission of nearly £20 millions is paid, the official estimate of all kinds of banking commissions being £50 millions.

#### AUTHORITY TO NEGOTIATE BILLS.

Bombay,  
13th May, 1930.

Messrs, Arjun Khimji,  
Bombay.

Dear Sirs,

We are instructed by the Midland Bank Ltd., London, to purchase your bills drawn on them up to the sum of £3,000 drafts to be drawn at three months sight against 400 cases of tinned goods consigned to order blank endorsed, drafts to be accompanied by full set of 'on board' bills of lading, invoice, insurance policy covering against all risks. This credit expires on the 28th June, 1930. Partial shipments are not allowed.

Sd. The Central Bank of India Ltd.

## AMERICAN EXPRESS COMPANY INC.

## Travellers Letter of Credit.

New York, 10th May, 1930.

£400-0-0

No. X19375.

sh<sub>1</sub> To all our Correspondents.Ant<sub>var</sub> Sirs,

there The bearer of this letter Mr. Howard Smith whose signature appears  
 outst the foot of this letter is hereby authorised to draw drafts at sight  
 sm the American Express Co., Inc., London, for Pounds Four Hundred  
 Only to which total extent we hereby engage that Mr. Howard Smith's  
 drafts shall be duly honoured by us on presentation.

All drafts under this Credit must bear the clause "Drawn under  
 the American Express Co., Inc., Letter of Credit No. X. 19375 dated  
 the 10th May, 1930.

This Letter of Credit is in force for six months from this date and  
 expires on the 10th November, 1930.

Particulars of drafts negotiated under this Credit should be noted  
 on the reverse and the Letter should be attached to the draft which  
 exhausts the Credit.

We are, gentlemen  
 Your obedient servants,  
 The American Express Co., Inc.  
 Sd. F. P. SMALL, *President*.

Signature of Mr. Howard Smith.

## COMMERCIAL LETTER OF CREDIT.

Credit No. D. 564.

New York,

Messrs. Carpet Manufacturing Co., Amritsar.

10th April 1930.

Dear Sirs,

By order of John Wanamaker, New York, we hereby open our  
 confirmed Letter of Credit No. D. 564 in your favour to the extent of  
 Dollars Five Thousand Six Hundred and Seventy only payments to be  
 made against the usual documents with bill of lading evidencing ship-  
 ment of 200 bales of carpets of "D" quality, prices c.i.f. New York  
 consigned to order blank endorsed. Partial shipments are allowed.  
 This credit is available until the 26th August, 1930. We undertake to  
 honour all drafts negotiated in accordance with the terms of this credit  
 on or before the date of expiry.

We are,  
 Dear Sirs,  
 Yours faithfully,  
 The National City Bank of New York.  
*President*.

Countersigned.....  
*Treasurer*.

## IRREVOCABLE CREDIT.

Credit No. C. 456.  
Thos. Wilson & Co.,

Calcutta,  
25th May, 1930  
e) a

We hereby open an Irrevocable Documentary Letter of Credit No. C. 456 in your favour for account of Smith Robinson and Co New York, for a sum or sums not exceeding £275-0-0 (Pounds Hundred and Seventy Five only) available by your drafts on <sup>fts</sup> Robinson & Co., at 60 days sight, documents against acceptance, to be accompanied by full set of

On board bills of lading  
Insurance policy against marine and war risk  
Consular invoice or commercial invoice  
Certificate of origin

evidencing shipment of forty pieces of carpets ten feet by eight of "D" quality, the amount to include all expenses in connection with the shipment c.i.f. New York.

All drafts under this credit should be marked "Drawn under Credit No. C. 456 of Chase National Bank of the city of New York." There must be forwarded by direct mail, the following documents to the Chase National Bank of the City of New York, the remaining documents to accompany the drafts:—Bill of Lading and Consular Invoice.

The amount of any draft under this credit must be endorsed on the back of this Letter of Credit and the presentation of any such draft by the holding bank is a guaranty that such an endorsement has been made and that documents have been forwarded as specified herein. The credit must accompany the final draft under it and must be surrendered with payment of the draft.

We hereby engage with the drawers, endorsers and *bona fide* holders of any such bills drawn under and in compliance with the terms of the credit that the same will be duly honoured on presentation by acceptance and payment on the due date.

This credit expires on the 28th September, 1930 and all drafts under it must be negotiated on or before that date.

Lloyds Bank Ltd.

## EASTERN BANK LTD.

## Advice of Confirmed Revocable Credit.

sh.

Ant. ar

there t No. C. 465.

outs ndass Manordass &amp; Co.,

sm, r Bombay.

Bombay,

18th June, 1928.

Dear Sirs,

Kindly note that under instructions by telegram (mail) we have been requested by the Westminster Bank, London, to advise you that a credit has been opened by them in your favour for account of Messrs. Jones Lloyds & Co., Birmingham, for £500 (Pound Five Hundred only) available by your drafts on the Westminster Bank, London at 60 days sight against the following documents in duplicate :—

Commercial invoice

Consular invoice

Insurance policy for marine risk and

Full set of bills of lading.

evidencing shipment of 2000 tons of scrap iron, c.i.f. Liverpool. Shipments should be effected on or before the 25th October, 1928 from Bombay or Karachi to Liverpool.

Drafts under this credit must be presented to the Westminster Bank on or before the 25th November, 1928.

Kindly note that this advice is given for your information and guidance and without any responsibility on the part of this bank and the credit is subject to cancellation at any time without notice to you. But we do confirm that the Letter of Credit has been rightly issued at the instance of and under the authority of the Westminster Bank, London.

Yours faithfully,

Sd. J. Jones.

Manager

## APPLICATION FOR DOCUMENTARY CREDIT.

To

The National Bank of Utopia,  
Utopia.

We request you to establish for our account by mail (cable) a credit on the following terms :—

credit : revocable (irrevocable)  
available at Timbuctoo

in favour of Johnson & Co., 185 East Avenue, Timbuctoo.

to the extent of £2,000, say two thousand pounds, available by drafts at sixty days sight drawn on the Lombard Bank, London, and documents as below covering 130 bales of sunshine in one or more shipments for cost at £15 per bale c.i.f. this city, to be despatched by fastest steamer with transhipment.

Documents :—

Invoice

Full set of bills of lading to order and blank endorsed

Marine risk policy covering 20% above invoice value of goods  
Consular Invoice.

Insurance to be effected by shipper.

We undertake to keep the said merchandise properly covered by insurance after arrival in this country against fire and other usual risks and to produce the policies if called upon to do so and in the event of our failure to do so, you are free to insure them.

This credit is to remain revocable at our instance. In consideration of your opening the credit we hereby undertake to accept and to arrange for payment in due course of all drafts drawn within the terms thereof and to put you in funds to meet your acceptances and in default of our doing so you may sell the goods before or after arrival. You are to have a lien on all the goods and documents and policies covering the goods for all obligations or expenses caused to you by your issuing the credit.

The transmission of instructions under the above credit and the forwarding of documents are entirely at our risk. You are not to incur any liability beyond seeing that the drafts and documents purport to comply with the terms and conditions of the credit.

You are authorised to debit our account with any sums paid under this credit and with commission charges.

Yours faithfully,

Sd. WUN CHOW SING & Co.



## CHAPTER XXVII

### BILLS UNDER CREDITS.

*"Stick to the law and the law will stick to you."*

Points for examination—Points explained—Bills of lading—Insurance—Insurance in India—Protection for Indian companies—Credits in Indian foreign trade—Advantages of credits.

The following points call for examination when a bill under a credit is offered for negotiation :—

1. Has the credit expired or been revoked?
2. Are partial shipments allowed?
3. Is it properly signed on behalf of the drawer?
4. Is it within the amount of the credit?
5. Is the drawee properly named?
6. Is the proper reference made to the credit?
7. Is the bill properly worded and stamped?
8. Does the invoice describe the goods correctly?
9. Do the goods tally with the goods called for by the credit?
10. Is the set of bills of lading complete?
11. Does the bill of lading testify to actual shipment?
12. Is the bill of lading deliverable to order?
13. Is the bill of lading clean or is there any marginal notation?
14. Is there an insurance policy?
15. Are there any peculiar conditions in the credit that are not satisfied?

Some of the points of examination are easily understood but some are not so easy. In some cases the credit calls for drafts being drawn on the importer and not on the bank issuing the credit, which is the usual practice. Insufficient stamping may even invalidate the rights of future holders besides making them subject to fines for evading the stamp. If there is a negotiable copy of the bill of lading in other hands, that could be made the basis of claim by unauthorised parties for obtaining possession of the goods.

The credit may call for one shipment only in which case it expires with the bill presented. If partial shipments are allowed it will be the business of the bank to write in the amount of the bill negotiated so that future purchasers would know the exact amount availed of by the exporter. If the

shipment creates a bill in excess of the credit, the conservative attitude is to reject the bill but it would be quite in order to ask the exporter to make out two new drafts, one for the balance of the credit, which the bank could buy with safety and another for the excess amount, which the bank would take for collection or advance against if it was satisfied with the standing of the exporter. If the amount is very small in comparison with the amount of the credit, there would not be much risk in paying for the whole draft.

The bill should be duly signed by the beneficiary or his authorised agent. Though the paying bank does not guarantee the genuineness of the documents, it does guarantee that the bills have been drawn by the exporter and that he has availed himself of the credit to the extent of that bill. If the goods are properly described and the documents are in appearance correct, the negotiating bank is not liable. It was laid down in *Guaranty Trust Co. v. Hannay* that the bank does not guarantee the genuineness of the documents nor the nature of the goods, and that the protection extended to the accepting bank also who could debit the customer for the value of the bill at maturity. In a remarkable case of cheating, a bank employee in Antwerp shipped goods (actually bricks) to a firm of crooks in New York who had arranged with a bank there for a credit covering metal products from Belgium. The bills of lading described them as metal products and in this manner the "combination" made several shipments before the fraud came to light. Thereupon, the negotiating banks were called on to defend themselves on the ground that they did not exercise proper caution in buying the drafts. But it was found that all the papers were in apparent order and the banks were held not liable; and the bank who issued a credit for a party on whose standing it could not depend had to suffer.

If the bill of lading merely stated that the goods were received for shipment it is called a "received for shipment" bill of lading and would not be a proper delivery under a c. i. f. contract. In the case of *"Diamond Alkali Co. v. Bourgeois"* (1920) Mr. Justice McCardie dissenting from a previous decision of the Privy Council held that, under a c. i. f. contract, the

bill of lading must pass over complete control of the goods and such control of the goods cannot be acquired unless the goods are actually moving and there is the definite possibility of their arriving in the importer's country in a reasonable time. Such assurance is given by an "on board" bill of lading. In cases, however, where the goods move partly by land and partly by sea or where the goods have to be transhipped at an intermediate port the through bill of lading cannot specify that the goods are on board any particular ship to the port of destination and the only choice is to accept what is really a "received for shipment" bill of lading. The credits in such cases would be qualified in this respect.

The International Chamber of Commerce has recommended that "received for shipment" bills of lading should also be accepted as this will enable the documents to go forward in time. We have seen that exporters from Italy, the Levant and some other countries are unable to forward the documents in time to India and that importers have to clear goods under a bank's guarantee. This could be avoided if the Chamber's suggestion is accepted.

At the time of negotiation the bills of lading must be deliverable to the bearer or the bank itself. Otherwise it may be necessary to depend on the consignee's endorsement or if an endorsement is lacking it might be necessary to send them back for securing endorsement, involving waste of time and expenses in storage and other charges and delay in obtaining possession. Moreover, in most cases, the steamship agents insist on the freight being prepaid but it is not impossible that freight may be payable on delivery. In this case, the steamship company has a prior right to the goods for its claims and it could sue the parties whose names appear as consignees. If the bills of lading have been made out to order and blank endorsed, this difficulty does not arise though the bank is protected by the ruling in *Sewell v. Burdick* (1884) where it was held that the bank could not be held liable for freight. But if it desired to obtain control over the goods, it would, of course, have to pay the freight and do so. The legal position is that the right in the goods pertains to the shipper, subject to the security he

has given to the banker through the letter of hypothecation and all liabilities under the bill of lading are his and his only.

The bill of lading may have some marginal notation which would detract from its value. It usually certifies that when the goods were delivered to the master of the ship they were "in apparent good condition" even though the goods may have been well packed. But if there is some defect in packing it might be mentioned in the margin and this could easily be made a pretext for the drawee to refuse to honour the bill.

The last named condition sometimes becomes very important. In the case of an Italian credit which called for bills of lading with *alongside clause*, the term was understood in India to mean that the goods might be alongside the steamer (not necessarily shipped), that is, the bill of lading might be one showing the goods as "received for shipment" but when the documents were received in Italy it was claimed that what was wanted was a bill of lading with permission to take off the goods from alongside the steamer when it arrived in port. As the actual bill of lading did not permit this, the importer claimed that the ship had to dock at the wharf and he lost about £150 on a shipment of iron scrap worth about £500. The bank was sued for the money and though a finding in its favour might have been very doubtful if the case had been tried in India, the cause of action was supposed to have arisen in Italy and the Italian Courts decreed in favour of the importer and against the bank.

In some countries as in France certain classes of goods have to be certified by its Consul abroad as being fit for import. If such certificate is not among the original documents it will have to be obtained before the goods can be cleared through the Customs and the bank should see to this before negotiating bills. Sometimes "weight notes" or "weight certificates" are called for. These are issued by dock companies or port authorities certifying to the gross weight of the shipment when it was exported. Shipments to the United States call for a **Consular Invoice** when the value of the goods exceeds \$100.00. This is a commercial invoice certified by the American Consul as representing to his best knowledge the true value of the

goods in the country of origin. The Consul makes a slight charge for certifying the invoice. It is made out on standard forms supplied by the Consul in quadruplicate, two of which are returned to the shipper, one is recorded in the local office and another is sent to the Customs authorities in New York. These invoices are necessary to help the goods to be assessed for duty and are very important, as the American tariff duties are very high and the actual assessment on the spot might be costly to the importer.

The insurance must be in the form of a policy ; and a certificate of insurance or a statement by a broker that the goods have been covered by insurance would not be suitable documents for a c. i. f. contract. The bank buying the bills pays for the documents and unless they are such as to ensure satisfaction of insurance claims they cannot be valid documents. This point was finally decided in the case of *Scott v. Barclays Bank*. The International Chamber of Commerce has suggested that insurance certificates should be accepted instead of policies\* but British bankers pointed out that the decisions are against this and, as the law in India generally follows British law, separate policies should be called for both for exports and imports unless the credits explicitly provide for certificates to be accepted.

In certain countries, importers and exporters practically insist on taking out insurance with their own national companies. In the case of exports this is an easy matter as it is the usual custom. But in the case of imports the bank buying the bills would not feel itself safe in the absence of the policy as, in the case of loss of goods, it might have difficulty in establishing its claim with the underwriters. The system is however largely in vogue in the United States. The importer has a "blanket" policy or "floating" policy, under which the insurance company holds him covered provided he furnishes it as soon as possible with the full description of the goods, the name of the vessel, the amount to be covered and other particulars. Whether the goods move under credits or otherwise, the foreign exporter would have to send a cable to the importer

\* Bulletin - Uniform Regulations for Commercial Documentary Credits.

giving the particulars and the policy comes into force immediately as regards them.

The Indian exporter has generally the right to insure in India but, until some years ago, the only companies available were foreign ones. Even now when very good Indian concerns are in existence his freedom is curtailed by the attitude of the banks. The insurance policy being designed to protect the importer and the negotiating banks during transit of the goods, it has to be issued by a company acceptable to them. Exporters therefore cannot be certain that the policies of Indian companies will not be rejected on arbitrary grounds by the banks. The Central Banking Enquiry Committee which went into the question did not feel able to make any effective suggestion and has left it to the good sense of the banks to distribute the business to Indian companies also. In the discussion with the foreign experts it transpired that, in every country, the national companies obtained the export insurance at least. In India with an export trade of about 300 crores we are paying an annual tribute to foreign companies of something like 50 lakhs after meeting all their expenses and claims in India.

It may well be asked whether the Government would not be justified in prescribing an arbitrary limit to the export insurance business that can be given to the foreign companies and, for this purpose, it might adopt a system of licensing and protection as was adopted in Czechoslovakia. After all, in spite of the size of our foreign trade and the fact that India is ranked as the sixth among the commercial nations of the world, as a nation we are worse than the smallest nation that has had "self-determination". In the discussions at the International Conference of 1929 on the Treatment of Foreigners, it was admitted that it would be permissible for the signatories to the Convention to restrict the freedom of foreign firms and individuals in certain spheres of activity and insurance was among them. Further, India was accepted as a backward nation for this purpose and it was admitted that she could pass legislation to reorganise certain trades and industries in the interests of her nationals.

In Czechoslovakia the new Government of 1918 "was given

the opportunity to protect the home insurance enterprises, and to aid their development in a way that would correspond with the *interests and the general economic programme of the country.*" Again, "Further facts to be taken into consideration were that in foreign countries the economic possibilities for Czechoslovakian companies were very limited and that home enterprises needed a certain amount of protection."\* These words might be applied, word for word, to conditions in India and it is useful to study the results of the Czechoslovakian programme. In 1918, 21 foreign companies were working in that country and the "Slavia", the only native concern had been driven out of it. In 1927 there were no less than 65 companies with headquarters in it and 21 outside companies. Is it too much to expect similar results in India if the "Indian Government" take up the same attitude?

When bills are received against import credits, it will be the business of the issuing bank to see whether the terms of the credit have been fully complied with and whether the documents have been made out correctly. If any irregularities are noticed, the forwarding bank should be notified as soon as possible, so that indemnity may be given, if necessary, or the errors may be corrected with the least possible delay. It may sometimes happen that owing to some irregularity which could not be corrected, the goods would lie in the docks or under Customs supervision and be not available for the importer just when he wants. If the mistake is non-essential, it may be rectified by a guarantee being given on behalf of the negotiating bank.

Very little of the import trade of India moves under credits. The reason is that importers are generally believed to be men of small means and banks in India, as we have seen, are not able to obtain that type of information which they want. They will not, therefore, open credits for them. Nor will they open irrevocable credits in any case, for that would bind the issuing bank during the whole life-time of the credit, and the banks do not wish to undertake the risk. Revocable credits are occasionally issued with bills to be drawn on the importers

\* "Sixty years of Insurance Service" by V. Peca, General Manager of "Slavia."

and not the banks. As a class, these bills would not be so valuable in the markets of the world, but the case in India is somewhat different. As there is no discount market in India, the cost to the importer is the same whether the bills are accepted by the bank or himself, as 6% is uniformly charged on all inward bills unless the bills are retired under trust receipts or loans, when the charge is higher, being at bank rate with a minimum of 6%. In practice the value of a bank acceptance is that the holder can raise money by discounting it, at a cheaper rate than by a trade acceptance. But in India there is a tradition that banks would lose prestige if they discounted bills or borrowed on them, and it is a matter of indifference who the acceptor is. The advantage of making the importers accept the bills is that the banks get the additional guarantee through it that the bills will duly be honoured by payment on the due date.

The most important reason perhaps is that India does not buy her goods but foreigners sell their goods to India. This may seem paradoxical but it is a fact. Indians do not go abroad and choose the best market for buying the goods they want. It is the foreign manufacturers who market their products through sales agents, correspondents, and branches in India. Having the goods almost at the door, Indians do not try to find out if they cannot get a better return for their money at other places or if a better class of goods is not available at the same price. So long, therefore, as goods are sold to us, the reports of the local agents are the things that count, and the foreign exporters send out goods on their recommendations with credit terms, sizes of shipments and volume of business as suggested by them. They depend on the local agents to take suitable action if the bills are not honoured and to sell the goods to others. Consequently, even the revocable credits are not required in several cases. Even where the customers asking for credits are well-known, the banks insist on getting a deposit of ten to thirty per cent to protect themselves against the risk of failure of the parties. The current account of the client is of little value in this case as it is a liability payable on demand and the bank has no lien on it.



In the case of the Indian exporters, credits are again conspicuous by their absence. The foreign banks would depend on the local banks for reports as to the reliability of the accreditees and banks in India are in the same situation as with regard to the importers. It, however, happens that exporters are mostly Europeans and the banks are able to give good reports about them on account of their intimate contact with them. Whether the credits are revocable or irrevocable, the trust which the banks place in them makes it possible to buy their bills, a facility which is not so easily available to the Indian exporter.

It may be useful to summarise the advantages of the commercial credits. The issuing bank, instead of having an agent on the spot to watch over its interests, obtains the services of all the banks in the exporter's city as they must protect themselves by proper scrutiny of the documents before paying for them. They would further be scrutinised by the issuing bank before the importer is asked to take up liability for the bills. The latter is able to obtain control of the goods without actually having to pay for them. The very fact that credit facilities are available to him enhances his reputation with the exporter. He has also the satisfaction of knowing that the exporter is considered responsible by the bank who has recommended the issue of the credit. The negotiating banks can buy the bills with an easy mind without worrying about the credit standing and integrity of the drawer and the drawee, for they know that the foreign bank's guarantee is behind them all. The discounters can depend more safely on the signatures of the banks than on those of the importers and exporters. The exporter is able to manufacture his goods or to go on with his buying programme with the assurance that the purchase contract will not be abrogated in normal conditions. He need not wait for several months for the goods to reach the importer and the value of the goods to be transmitted to him. The quicker turnover enables him not only to increase his shipments but also to do the business on a smaller margin of profit. Small profits but quick returns make him capable of capturing the markets and this places him in a very decided advantage over the ordinary shipper who is hardly able to put through one

transaction to five of the others. The bank itself rarely pays out any money but only lends its credit, in order to make the exporter's bills attractive. The duty of watching over the solvency of the importer is no longer the concern of the exporter but for the issuing bank. And all these benefits accrue to the whole commercial world through the signature of a bank official to a Letter of Credit. Truly, if faith can move mountains, '*credit*' can move mountains of goods all over the world.

## CHAPTER XXVIII.

### EXCHANGE ARBITRAGE.

*"I will wind a girdle round the earth"*

Kinds of arbitrage—Currency or exchange arbitrage—Three point and other arbitrages—Effects of arbitrage.

An arbitrage operation is one in which two or more banks combine to send funds from one country to another until they reach back to the starting point. The funds may finally be in the form of the original local currency or in legally convertible form, such as gold or silver. They may also be in a form intermediate between these two, that is in the form of stocks.

Certain stocks enjoy an amount of international reputation and are bought and sold freely in many stock exchanges. If the quotations in two centres are at variance with the exchange ratio, then the banker could buy the stock in that country, then ship it to the other, sell it in the dearer market and recover his money. Thus if an issue of 4% Bonds of the British Government is sold in Paris at Fcs. 12500 and in Berlin for 2056 Reichsmarks, while marks can be bought in Paris at  $608\frac{1}{4}$ , marks  $2056 = 2056 \times 6.0825 = \text{Fcs. } 12505.62$ . If the banker invests Fcs. 1,000,000 in the operation, he can buy stock of the face value of £8,000 which he can sell in Berlin for RM.  $80 \times 2056$  and by selling the marks, he can get Fcs.  $80 \times 12505.62 = \text{Fcs. } 1,000,450$ . After deducting expenses he can make a profit of about 400 francs on the transaction.

Currency or exchange arbitrage may be direct or indirect. A case of direct arbitrage would arise, for example, if the

Bombay office of a bank bought sterling and the London office bought rupees. The difference between the original amount and the one returned is the profit on the transaction.

Thus if Bombay buys £10,000 at  $1/6$  for Rs. 1,33,333 roughly

The London Office buys Rs. 133,000 at  $1/58\frac{1}{2}$  for £9,925-10-0

There is a shortage of Rs. 333 in India and a surplus of £42-10-0.

in London which would give about Rs. 563

This would leave a net profit of Rs. 230.

Similarly, both might sell instead of buying. Thus:—

London sells Rs. 1,50,000 at  $1/6\frac{1}{8}$  for £11,289-5-0

Bombay sells £11,300 at  $1/6\frac{1}{8}$  and receives Rs. 1,50,403

There is a surplus of Rs. 403 in Bombay and a shortage of £10-15-0

in London which can be sent by D. D. for Rs. 143, leaving

a profit of Rs. 403-143=Rs. 260.

A case of indirect arbitrage would be when a bank in Bombay sold T. T. on London and London sold francs for the sterling, and the Bombay office bought the francs. Whenever any three currencies deviate from their parity values in terms of each other, the arbitrageur makes his appearance. He buys at the cheaper centre and raises the exchange rate there and sells in the dearer centre and depresses the rate there, thus bringing about a new set of rates which are in equilibrium. The transaction may be described diagrammatically thus:—

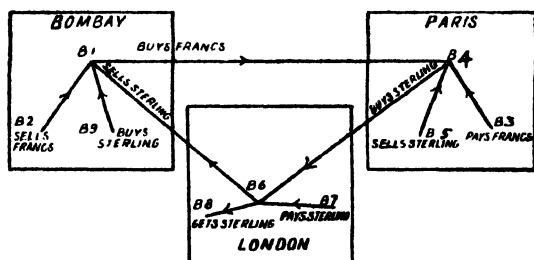


Diagram 18—The Exchange Arbitrage

- (1) Bank number one or  $B_1$  buys francs from  $B_2$ .
- (2)  $B_3$ , agent of  $B_2$  in Paris, pays  $B_4$ , agent of  $B_1$ .
- (3)  $B_4$  buys sterling from  $B_5$ .
- (4)  $B_6$ , agent of  $B_1$  in London receives sterling from  $B_5$ , agent of  $B_3$ .
- (5)  $B_1$  sells sterling to  $B_9$ .
- (6)  $B_6$  pays sterling to  $B_8$ , agent of  $B_9$ .

On the other hand, if the francs were cheaper directly than to buy through London, the process would be the other way round. Bombay would buy sterling, London would buy francs and Bombay would sell the francs. Similarly, the trans-

action might be in dollars, sterling and rupees. Thus, if dollars were 274 in Bombay and sterling was  $1/6$  in Bombay and dollars 485 in London, dollars could be sold through London for  $\frac{240 \times 100 \times 100}{485 \times 18} = 274.9$  and there would be a profit of .9 rupees on every 100 dollars dealt in, less expenses. We should find that the operation has opened the eyes of people to the facts of the situation and the seller of dollars would ask for  $274\frac{1}{2}$  while the buyer of sterling might begin to demand  $1/6\frac{1}{2}$  and the dollars might realise less sterling in London because  $485\frac{1}{8}$  was wanted. The result is that the profit of the arbitrageur has disappeared as the rates are now at parity. If one tries to do the transaction at these rates, he might find that instead of a profit he might have to face a loss on it. A good arbitrageur requires plenty of funds to play with, but he makes the profit in the quickest time as his funds come back to him in a day or two.

If dollars are bought in Bombay at 274 and sold in London at  $485\frac{1}{4}$  and sterling sold in Bombay at  $1/6$  and the amount is \$100,000, the profit on the transaction will be as follows :—

\$100,000 at 274 = Rs. 274,000

\$100,000 .. = £ 100,000 ÷ 4.85¼ or Rs.  $\frac{100,000 \times 240}{18 \times 4.85\frac{1}{4}}$  = Rs. 2,74,772-7-3

Less cable charges &c. Rs. 40-0-0

Amount realised is Rs. 2,74,732-7-3, or a profit of Rs. 732-7-3.

If Yens can be sold in India at  $137\frac{1}{2}$  and can be bought in London at  $24\frac{1}{2}$  while sterling can be bought in Bombay at  $1/6\frac{1}{8}$ , the following transaction would happen :—

Bombay buys £7,000 at  $1/6\frac{1}{8}$  .. .. Rs. 93,172 nearly

London buys Yens 68,000 at  $24\frac{1}{2}$  .. £ 7,012-10-0

Bombay sells Yens 68,000 at  $137\frac{1}{2}$  .. Rs. 93,500

Bombay remits D.D for £12-10-0 for .. Rs. 167

Profit is Rs. 93,500 - 93,172 - 167 .. .. Rs. 161

If yens can be bought in Calcutta at  $136\frac{1}{8}$ , and sterling can be bought in Yokohama at  $24\frac{1}{2}$  while sterling can be sold in Calcutta at  $1/5\frac{3}{8}$ , the following would happen :—

Calcutta sells £10,000 at  $1/5\frac{3}{8}$  .. .. Rs. 1,34,031

Calcutta buys Yens 98,000 at  $136\frac{1}{8}$  .. .. Rs. 1,33,893

Yokohama buys £10,000 at  $24\frac{1}{2}$  .. .. Yens 97,959

Calcutta sells Yens 41 at 136 .. .. Rs. 56

The profit is Rs. 1,34,031 + 56 - 1,33,893 .. .. Rs. 194

The arbitrage may also be "compound" as when it involves three or four more foreign currencies. But such transactions are very uncommon in India though in Europe and New York they are fairly common. The arbitrageur's business is to watch the exchange rates not only in his own centre, but what is more important, at the other centres. It is the divergence from parities that gives him his opportunity. Cases have been known when an alert operator put through a transaction at about 12 Noon but it was not available half an hour later. For example, if it develops that marks are cheaper in Paris than they ought to be and liras cheaper in Berlin than they ought to be, a London banker buys francs, buys marks in Paris with them, buys liras with them in Berlin and finally sells the liras in London. There will be small balances in each centre as we have seen and after these have been liquidated, there will be a profit which might have to be shared with the agents in Paris and Berlin unless they have included it in the rate or have been given a flat<sup>31</sup> service charge. In this connection the greatest friend of the arbitrageur is the telephone which connects practically all the monetary centres in Europe. As soon as one learns of slight variations in the rates, he rings up the centre and asks his agent to sell or buy the particular foreign currency which has given rise to the arbitrage. The telephone service has thus brought the various centres into such close contact that they seem to be one market for practical purposes. The telephone service is now available also between New York and European centres.

1. If T.T. on New York is 279 in Bombay and New York on Bombay is 35·71, then buying rupees in New York is the same as selling dollars in Bombay at  $\frac{10,000}{35\cdot71} = 280\cdot28$  nearly.

Therefore, if Bombay bought \$35,000 at 279 it would cost Rs.  $35,000 \times 2\cdot79 =$  Rs. 97,650.

If New York bought Rs. 1,00,000 at 35·71 it would cost \$35,710·00. Bombay has Rs. 2,350 surplus and New York is \$710·00 short which costs at 280, Rs. 1,988 leaving a profit of Rs. 362.

2. London on Paris is quoted at 124, Bombay on Paris 928 and Bombay on London 1/6. What is the profit on buying £10,000 worth of francs through London and selling them direct in Bombay, allowing Rs. 30/- for cost of cables?

£10,000 at 124	..	..	..	= Fcs. 1,240,000
£10,000 at 1/6	..	..	..	= Rs. 133,333
Fcs. 1,250,000 at 928	..	..	..	= Rs. 134,699
Fcs. 10,000 at 928	..	..	..	= Rs. 1,078

				= Rs. 133,621
Less cost of cables &c.	..	..	..	= Rs. 30

				Rs. 133,591
Profit on the deal	..	..	..	= Rs. 258.

3. Yens are quoted in Calcutta at  $134\frac{1}{2}$  and sterling at  $1/6$ . If Yens are quoted in London at  $24\frac{1}{8}$ , which is the best way to send rupees round and what is the profit on a deal of £15,000 allowing Rs. 45 for cables and other expenses.

$$\begin{aligned} \text{Rs. } 134.5 &= 100 \text{ Yen in Calcutta} \\ &= 2,412.5 \text{ pence at } 24\frac{1}{8}d. \end{aligned}$$

$$\text{Rs. } 134.5 = 2,421 \text{ pence at } 18d.$$

Hence if we buy sterling we get more pence than we have to give away by selling it through yens.

£15,000 at 1/6	..	=	Rs. 200,000
Y. 150,000 at $24\frac{1}{8}$	..	=	3,618,750d. = £15,078-3-0
Y. 150,000 at $134\frac{1}{2}$	..	=	Rs. 201,750
Less cost of £78-3-0		=	Rs. 1,042
Less cost of cables &c.		=	Rs. 45
Amount realised	..	=	Rs. 200,663

Net profit on deal	..	Rs.	663.
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4. A bank can buy or sell T.T. on London at  $1/6$ . It can sell T.T. on New York at 275 or buy at 274. Its London office can sell T.T. on New York at  $485\frac{1}{2}$  or buy at  $485\frac{1}{4}$ . Is an arbitrage transaction possible? If so, how should the funds go round? What would be the profit on a deal of \$100,000?

$$\$4.85\frac{1}{2} = 1\text{£} = 240d. = \text{Rs. } \frac{240}{18} = \text{Rs. } \frac{40}{3}$$

$$\therefore \$100 = \frac{40}{3} \times \frac{400}{19.41} = \text{Rs. } 274.772.$$

Hence he can buy dollars through London at this rate and sell at 275. The profit on \$100,000 = Rs. 275,000 - 274,772 = Rs. 228.

$$\$100 = \frac{40}{3} \times \frac{277.00}{19.41} = \text{Rs. } 274.631$$

Hence he can sell dollars through London and buy at 274.

The profit on \$100,000 = Rs. 274,631 - Rs. 274,000 = Rs. 631.

5. A banker buys yens at  $134\frac{1}{2}$  which he sells in London at  $24\frac{1}{8}$ . What is the maximum rate at which he can sell T.T. on London so as to make a profit? What is his profit on buying Y. 100,000.

Y. 100,000 at $134\frac{1}{2}$	..	..	=	Rs. 134,500
Y. 100,000 in London at $24\frac{1}{8}$		=	£10,026-1-0 nearly	
£10,026-1-0 at $1/5\frac{3}{8}$	..	..	=	Rs. 134,380 or a loss.
£10,026-1-0 at $1/5\frac{1}{4}$	..	..	=	Rs. 134,615 or Rs. 115 profit.

7. A bank remits Reichsmarks from Bombay 40,000 RM. If Bombay on London is  $1/5\frac{1}{4}$  and London on Berlin is 20.50 what is the rate at which it should buy the marks and what is its profit?

$$\text{RM. } 40,000 = \text{£} \frac{40,000}{20.50} = \text{£} 1,951.4-0$$

$$\text{£} 1,951.4-0 \text{ at } 1/5\frac{1}{4} = \text{Rs. } 26,198.$$

$$\therefore \text{Rate for marks} = \frac{40,000}{261.98} = 152.68 \text{ or } 153$$

$$\text{The cost of marks } 40,000 \text{ at } 153 = \text{Rs. } 26,144$$

$$\text{The profit} = \text{Rs. } 54 \text{ nearly.}$$

8. A bank in London buys liras 2,000,000 at 89 $\frac{1}{2}$  and sells them in Paris at 1,379 and buys sterling there at 123.70. What is its profit?

$$\text{Liras } 2,000,000 = \text{£} \frac{2,000,000 \times 4}{359} = \text{£} 22,284.2-6$$

$$\text{For the liras he will get fcs. } 2,000,000 \times 1.379 = \text{fcs. } 2,758,000.$$

$$\text{Francs } 2,758,000 \text{ will buy } \text{£} \frac{2,758,000 \times 10}{1237} = \text{£} 22,295.17-6$$

$$\text{The profit} = \text{£} 11.15-0.$$

## CHAPTER XXIX.

### BULLION ARBITRAGE.\*

#### *"Argosies laden with gold"*

Bullion arbitrage between types of countries—Legal parity—Import and export parities—Actual movements of gold—Gold imports into India—The gold market—The silver market—The melting point of the rupee—Gold coin imports—Gold exports—Air service.

Bullion arbitrage is a process of buying bullion in the cheaper market and selling it in a dearer. But such a process is subject to the condition that the difference in prices is sufficient to take care at least of the expenses of transportation and a margin of profit. The expenses of transportation are freight, insurance, incidental expenses such as bank commission, loss of interest from purchase in one country and sale in the other. An arbitrage operation can ordinarily arise only as a result of a balance of trade. If country A has sent to country B more goods than it has bought it must receive a balance in the form of gold unless it invests the amount in the country B. In any country the exports and imports are spread over the whole year but there are seasonal variations with

\* Part of this chapter is based on notes of a lecture before the Sydenham College of Commerce Banking Association in 1921, delivered by the author.

heavier exports or imports in some months. It is in the months with heavier exports that bullion generally moves, though it is also possible that the bullion movements might be facilitated in other months by forward exchange contracts anticipating the future trade movement.

We have seen that though there is a fixed legal relation between the currencies of most countries, it is rarely that any two of them are in this relation. When the variation from it becomes wide enough from the par, gold movements become possible. Bullion movements may be classified as between countries of various types (a) gold standard, (b) gold exchange standard, (c) silver standard, (d) paper standard (for definitions of these terms see Chap. XXXI).

Gold standard countries used to believe before the war that it was an essential qualification of the gold standard that gold coins should freely circulate in the country. The movements of gold in those days became merely a matter of collecting coins from the country in sufficient quantity to make the shipment worth while, though, sometimes, gold coins were obtained from the Central Banks. In the country to which they were sent, they had, of course, to be melted, assayed and recoined. After the war the mentality of most nations has changed and gold coins are considered merely ideals represented in fact by notes and<sup>2</sup>gold bullion as the standard of value. This has one advantage in that it saves the cost and time of assay and minting. Except in centres like London and New York, where gold is always available, the only method of obtaining gold for export is to apply to the Central Bank, which will give it at its selling price in local currency. Bullion is now sold by the Central Banks only in large quantities in bars of about 400 oz.

In gold exchange standard countries as in purely silver standard and paper standard countries gold is merely a commodity and is imported at any rates of exchange so long as there is a demand from the public. When this ceases, import stops as the currency authority is not under obligation to buy the gold and even if it is, its price would be so low as to make gold imports prohibitive. Into silver standard countries,



silver could be imported and transformed into money. This money may be a standard weight of pure metal like the tael or may be minted into coins as in Mexico. In paper standard countries both gold and silver will be treated as commodities.

The legal relation between the standard units of any two countries is termed the "par" of exchange. Such legal relations can exist only when the basis of currency is the same as in the case of two gold standard countries or two silver standard countries or between a gold standard country and a gold exchange standard country. Between two gold standard countries it depends on the fine gold contents of the two standard units. Between two silver standard countries, it depends, similarly, on the fine silver contents of the coins of the two countries. Between a gold standard country and an exchange standard country, it is determined through the gold standard country with which the exchange standard country is linked. There can, of course, be no legal relation between any of these countries and a paper standard country. As shown in Chap. IX, there can, however, be a temporary parity value of exchange between a gold or gold exchange standard country and a silver standard country based on the gold price of silver at the moment but this parity value is very unstable and fluctuates with the value of silver. The actual exchange rate on a silver standard country moves around this ephemeral parity within certain limits. As gold coins are practically out of circulation to-day there is no more sense in calling the ratios "mint par" and the term "legal parity" could be applied to the relation between any two countries as the laws define the monetary units as having a certain value in terms of gold, silver or other gold or silver currencies.

So far as the legal coins are concerned, there is always a certain amount of alloy which gives them the hardness and whose value is negligible when compared with that of the gold or silver. The alloy is mixed in certain definite proportions and the coin is not perfectly fine, that is, of 1000 fineness, but is of what is known as standard fineness. There are two types of standard gold—one, the British type  $1\frac{1}{2}$ ths fine or 916.67 fine and the other, the standard gold of America, France, etc.,

which is  $\frac{9}{10}$  or 900 fine. Hence, gold coins which go from one country to another have to be assayed and raised or reduced to the requisite fineness before they can be coined into local currency. Silver is mixed in various proportions ranging from 45% for token coins to 92% for standard coins. The method of calculating mint pars and parities is illustrated below :

\$20·67183 = 480 grains in the U. S. A.

113·001 grains = 1£ in England.

$$\begin{aligned} 1£ &= \$ \frac{20 \cdot 67183 \times 113 \cdot 001}{480} \\ &= \$ \frac{2335 \cdot 9375}{480} = \$4 \cdot 8665 \\ &= \$4 \cdot 86\frac{1}{2} \end{aligned}$$

Gold is often shipped from one country to another though the static value is the same in both, because there is a difference in their dynamic values. Thus, if gold is comparatively cheaper in New York than in London owing to the exchange value of the pound being higher in terms of the dollar than the legal parity, people will try to buy the gold in New York and take it to London. The difference between the legal rate and the actual rate must then be enough to give the operator the cost of transportation such as freight, insurance, interest and bank commission. This rate is called the export parity from New York to London and it will, of course, be the import parity into London from New York. Similarly, if the rate moves so much that the pound is worth fewer dollars than the legal parity, then gold will move from London to New York if the difference will give the operator the cost of transportation. This rate of exchange is called the import parity into New York from London and the export parity from London to New York. The export parity is often called the 'lower gold point' and the import parity is called the 'upper gold point'.

The prewar export and import points between London and New York were based on the costs of transportation below :—  
London to New York 0.8% or 8 per mille and New York to London 0.5% or 5 per mille, the difference being due to the higher interest rates in New York in those days, the difference between the buying and selling rates for gold at the Bank of England and the time taken by the United States Assay Office

to certify the gold. Since the war these rates have been much cheaper due to lower freight charges, quicker transit time, saving in interest, and an arrangement by which the United States Treasury pays about 95% of the value of the shipment on arrival of the gold and adjusts the rest after the assay is over. The present costs are between 3.75 and 4 per mille. The export parity from London in prewar days was thus  $486.67 - 8 \times .486 = 486.67 - 3.9 = 482.7$  or  $482\frac{3}{4}$ ; and the import parity was  $486.67 + 5 \times .486 = 486.67 + 2.4 = 489.1$  or  $489\frac{1}{8}$ . Since the war the charges amount only to \$1.95 per £100 and the parities are  $486.7 + 1.95$  or  $488.6$  or  $488\frac{5}{8}$  for import and  $486.7 - 1.95$  or  $484.7$  or  $484\frac{3}{4}$  for export. If, however, banks handle the shipments the charges can be reduced to 3 per mille and the points will be  $486.6 - 1.4$  or  $485\frac{3}{4}$  for export and  $486.6 + 1.4$  or  $488$  for import. Gold will not, of course, move at exactly these rates because the banks which finance the movements of gold must make some profit and people would also try to avoid gold shipments, if possible, on account of the trouble, risk and expenses of moving gold. Consequently, the export parity from London will be  $484\frac{3}{4}$  in practice, import parity into London will be  $488\frac{1}{2}$ . The bank's profit in shipping the gold is the difference between the cost of laying out the gold in the other country and the proceeds of the sale of the foreign currency thereby created. The shipments may be handled by banks of either country and, in some cases, even by other banks.

These limits may be called public export and import points which are, in these days, somewhat different from the private import and export parities of the Central Banks. The gold reserves of most of them were depleted during the war-time and the note issue of the others was so inflated that not all the gold in the world could keep them on the gold standard. As the nursery rhyme might say :—

Humpty Dumpty sat on a wall  
 Humpty Dumpty had a great fall  
 Not all the king's gold  
 Not all the bank's power  
 Could set Humpty Dumpty up again.

Consequently, when the currencies were again stabilised, it became necessary for the Central Banks to acquire as much gold

as possible and they were prepared to buy gold at rates which would be much below import parity. Whenever the country had a favourable balance of trade, the Central Banks would buy the excess supply of exchange and use it to acquire gold assets abroad and use them for buying gold.

If the Bank of France imports gold from London when it is selling at 85/0 and the rate is 124.10, find the cost of importing it. The transportation charges amount to .35%.

$$.35\% \text{ of } 124.10 = .43$$

The import value of 1£ worth of gold is 124.53

$$1 \text{ oz. gold} = 85 \text{ sh.} = \frac{85}{20} \times 124.53 = 529.25 \text{ fcs.}$$

$$\text{But parity value is only } \frac{1018\frac{1}{2} \times 124.21}{240} \text{ or } 527.11 \text{ fcs.}$$

London and New York are the two free markets of the world. The price of gold as a commodity in London varies according to supply and demand. When supply is plentiful the price will tend to the rate at which the Bank of England will buy freely, namely Sh. 84/10 per fine ounce. When it is scarce, the price would rise higher than even the selling price of the Bank of England because, though the Bank would officially sell at 84/11½ per fine ounce it will do so only to satisfy the legitimate trade demands and not for allowing gold withdrawals against bank deposits. Hence, the price might move to 85/1 or even 85/2 in times of low supply. Moreover, the Bank is authorised to deliver light-weight coins though short by about 1%. When England is off the gold standard, as it was in September 1931, and just after the war, the price of gold in London would be much higher, being quoted at Sh. 100 and even Sh. 120 and, to this extent, it may be said that there is no limit to the rise in the price of gold in London.

The method of importing gold or silver into India is as follows:—The importer approaches a bank with a London office and enters into a 'bullion contract'. Under this contract the London office of the bank will pay a named broker a specified amount against delivery of full set of shipping documents. Interest from the date of payment to delivery in India is charged at London bank rate with a minimum of 4%. The importer has often to make a deposit of 5% for gold and 10% for silver. The bullion must be cleared from the bank's vault

within 10 days after arrival. Otherwise the Imperial Bank of India rate, minimum 6%, will be charged after the tenth day. The importer should buy the sterling cover from the bank or pay  $\frac{1}{32}$  d. as commission charge.

Since the B. I. S. N. Co. agreed to transport gold from Durban at a lower rate than the P. & O. from London there has been a small gain to the Indian buyer and the South African seller in saving interest and expenses involved in the journey to London. The arrangements for the imports from Durban are almost similar to those from London. Rothschild & Sons being sole agents for the sale of the gold output of South Africa, they have to be paid in London against advice from Durban that the shipment has been made. The bank in Durban advises the Bombay bank to this effect and the Bombay bank advises its London office to pay the amount and interest is charged from the date of payment in London. The transit time from Durban to Bombay is the same as from London, the service is a fortnightly one instead of the weekly London Mail Service.

At one time gold used to be bought in New York in preference to London. But now London has got back the business. The following were the gold imports for the last three official years :

<i>(In lakhs of Rs.)</i>	1928-29	1929-30	1930-31
From Durban ..	1,335	418	663
From London ..	329	220	208
From Australia ..	128	313	117

Silver also seemed at one time to have shifted from London to New York, particularly, as most of the silver on the London market was actually American production. But the advantages of the organised service of the British banks in India brought the business back to London. Now silver is invariably bought in London though sometimes from China. China also buys from India whenever a local surplus creates an export parity which makes purchase here cheaper than import from London. While gold in London is always sold for ready delivery, silver is sold for ready and for two months forward delivery. The latter quotation is chiefly to meet the requirements of American

smelters who would require that period to execute the orders. It also suits the silver dealers as they are able to push off purchase and sale contracts and thus hedge themselves. The London quotation is for standard silver, 925 fine, and the Indian quotation is for fine silver of 995 to 998 fineness. Consequently, a London quotation of  $12\frac{3}{4}$ d. is equivalent to  $13\frac{5}{8}\frac{1}{2}$ d. for fine silver and it is this price that should be converted into rupees per 100 tolas. The Chinese quotation also is for fine silver 992 to 1000. The forward quotation in London is always very near the ready quotation differing only by  $\frac{1}{16}$  to  $\frac{1}{2}$  of a penny.

• Silver is also a bye-product of the Burma mines and has also been available in recent years through sales by the Indian and other Governments from demonetised coins. This factor, due to their conversion or return to the gold standard, has depressed the price of silver so much that it became necessary to protect the value of silver holdings in India by imposing an import duty of four annas per ounce, which has now been raised to 6 annas per ounce or an increase in the local value of nearly Rs. 14-8, and yet the quotation was only about 43 rupees per 100 tolas in May, 1931.

But the Government have not used this protected market for disposing of their silver and have been selling in London at a loss to both parties. Thus if silver in India ex-duty is sold at Rs. 28/- the purchasers would buy it for Rs. 27-12 at least, and, allowing for the cost of transportation, the London price would be Rs. 27-6 and, as the Government incur the same cost in sending their silver to London, they can only realise Rs. 27/- net per 100 tolas. The duty does not enter into the calculation because if they sell a certain quantity in India at Rs. 28/- plus duty, they lose the duty on a corresponding quantity of silver imports. The net loss to the Government in selling in London is therefore about 3% on the annual import of silver which has been about 13 crores for the last two years and 16 crores average for the last five years, with a loss of 40 lakhs per year to the Government.

Since the closing of the mints in 1893, rupees have been merely notes printed on silver and their value has been unrelated to the value of the silver contents. The rupee contains

165 grains of fine silver, and 15 grains of alloy, weighing together  $\frac{3}{8}$ th of an ounce. At the recent price of  $12\frac{1}{2}$ d. the silver content is worth only about  $4\frac{1}{2}$ d. or about 4 annas. But when silver is worth Rs. 109/- or more per 100 tolas, which would be if silver to-day were quoted in London at above  $48\frac{1}{2}$  pence gold, it will be worth while to melt rupees rather than import silver. Such a contingency did arise during the war-time when the scarcity of silver raised the London price to  $89\frac{1}{2}$ d. and though the Government successively raised the external value of the rupee to 2sh. 8d. it was unable to compensate for the rise in the silver price. Consequently, it was quoted as high as 116 rupees for 100 tolas and, to prevent rupees being melted the Government had to make it a criminal offence. With the introduction of a full gold standard this danger can be avoided by issuing rupees with less silver content, like the shilling and other token coins, by the more popular use of Reserve Bank Notes and by restricting the issue of silver rupees so as to prevent their being in excess of monetary requirements.

The bullion markets in India are principally situated in Bombay with subsidiary ones in Madras, Calcutta and some of the bigger cities and towns. But these are not as active as Bombay which determines the price for the rest of India which buys chiefly from there. Gold being largely consumed in Madras, imports are into Bombay and Madras, the figures being :—

	1928-29	1929-30	1930-31 (in lakhs).
Bombay ..	1,326	891	878
Madras ..	759	472	343

Silver is more popular in Bengal, Bihar and Orissa and the imports come in through Bombay and Calcutta principally, the figures being :—

	1928-29	1929-30	1930-31 (in lakhs).
Bombay ..	1,103	965	906
Calcutta ..	462	338	331

The busiest gold season is February to May which is the marriage season for Madras and the slackest is July and August. For silver the busiest season is January to July and the worst months are August and September.

Bullion is not generally imported into India on the basis

of ready prices here, but mostly on the basis of forward prices. There are usually two settlements in Bombay for silver and gold for which quotations are available. The day after full moon and the five succeeding days are allotted for gold and the fifth day to tenth day for silver. The first settlement is after the next full moon and the second follows the next after that. The most important business is that for the first settlement until it comes within 20 days of the actual clearing date, when it becomes impossible to import bullion for that settlement delivery. Prices for first settlement then tend to ready and move with the demand for up-country consumption (the off-take, as it is called), and the "visible" supply. From this time the second settlement becomes the basis for imports though for intermediate periods shipments are brought in and sold for delivery after arrival of a named ship.

Up to 1929 good delivery for settlement required handing over of English bars of gold or silver with the British hall-mark. Indian gold and silver refined here used to be sold but at a discount of three or four annas per tola for gold and two rupees per 100 tolas for silver. In 1929 the Bombay Bullion Exchange decided to accept deliveries of Indian refined silver and gold as good. Consequently, the discount on silver disappeared but the discount on gold did not and though the National Bank of India sells the production of the Mysore mines, the gold does not command as good a rate as the bars with the London hall-mark.

Bullion movements into India have been persistent in years of good and bad luck. Whether exports have exceeded imports or have been under them, gold imports have gone on, as the nation must have gold and silver for jewellery purposes in just the same way as it wants foreign cloth. But there are many occasions on which silver has freely left the country though gold exports are rather rare. When prices are attractive, as in 1921 when the rupee stood at 12d. gold and silver was quoted at about Rs. 33 per tola, gold was sold by holders at one or two annas under export parity, being confident that it could be bought back at lower prices, though they never expected it to go as low as Rs. 21-4. In 1921 alone not less than 30 crores of



net exports were made chiefly to New York, the major part of which was handled by the Guaranty Trust Co. of New York. This represents over one crore tolas or nearly four million ounces which is one-fifth of the annual output of the world. The export of over two crores of gold in one week, in September 1931, when the price rose from Rs. 21/6/- per tola to Rs. 25/4/-, may also be referred to.

The basis of the forward rate for gold is twofold, the rate at which forward exchange is available and the demand for it in the country. It is sometimes below ready but usually above it. Normally it is only one to two annas from that rate but when the bulls are in command the difference may widen to even four annas and when the bears are raiding the market, it might go as far below it. Sometimes, the price in London goes higher than the usual  $84/10\frac{1}{2}$ , when the Indian demand is met from New York, involving higher costs of transportation. The silver quotation has an added factor, the price of silver itself in London; and with low demand the price in India might go as low as export parity to Shanghai which is about 1% and a good demand would send the local rate up by the same margin over the parity price.

The local price for gold or silver must therefore be near the import parity from London if imports are to take place. The costs of transportation include brokerage in London, cost of the bullion, interest for transit period, freight and insurance. These total about 1.2% and in the case of large shipments might be kept down to 1.16%. Thus, if  $p$  be the price in pence in London,  $r$  the rate of exchange, the price of gold in India

$$= \frac{p \times 3 \times 1.012}{r \times 8}$$

and the price of silver 
$$\frac{p \times 40 \times 3 \times 1.0125}{r \times 37 \times 8}$$

Examples of the price calculation are given at the end of the chapter, as also of various other rates. As  $p$  is nearly constant except in special circumstances, the price of gold in India is inversely proportional to the exchange rate and will fall when it rises and rise when it falls.

Sovereigns are popular in India for several reasons, the chief being that they can be used as such for pendants etc.

Secondly, there is no need to test the fineness of the gold. Thirdly, when it is necessary to borrow on their security, they give an easily ascertainable limit for the lender and it is also easy to identify them when the loan is repaid. The importance attached to gold coins is shown by the fact that though they are more costly, being at a premium of one anna per sovereign, they are imported in large quantities. The following are the figures in five year averages between 1900 and 1930 :—

(In lakhs of rupees)	1900-05	1905-10	1910-15	1915-20	1920-25	1925-30
Bullion ..	572	966	1,350	1,494	2,854	1,374
• Sovereigns ..	915	784	1,642	670	991	792

It will be seen that in prewar years the coins exceeded ordinary bullion and that it is only now that there has been an abatement in the demand for them.

A movement of gold or silver in or out of a country must be regarded as a movement of commodities. In the case of gold standard countries gold has also a legal value by which it is possible to obtain its price back again without depending upon a market, and silver has a similar value in silver standard countries. In other countries they have only a commodity value which varies with the industrial demand for them. Consequently, the imports as commodities would be handled by ordinary traders while the imports as currency shipments would be handled by the banks themselves. The position in India is peculiar as the price rarely comes near the export parity value of the Government of India, nor near its import parity value. The industrial demand is normally sufficient to keep it well away from them. The business is, therefore, in the hands of the bullion dealers but, when exports are made, they are financed by the banks as their own operations.

Owing to the efficiency and reliability of the air service in Europe gold sometimes moves by air and the costs of transportation are reduced. But the idea is not yet popular and gold parities on their basis are not established. Air mail for gold transport is available between London, Paris, Berlin and Amsterdam. Air mail for the United States is still a dream and though the service is working to India, gold is not being imported by air. But, if the idea catches on, it will not be due

to the small saving in interest, but because of the time element, as shipments could be made from London within twelve days of the settlement. The cost of the shipment might be prohibitively high but, in a bull market, this would not matter. There is also the possible advantage that the journey is mostly over land and, if the airships break down, the gold can be recovered.

1. Find the legal parity between the rupee and the dollar.

$$\begin{aligned}
 1 \text{ rupee} & \quad \dots \quad \dots = 18d. \\
 24d. \text{ or } 1\text{£} & \quad \dots \quad \dots = 113\cdot001 \text{ grains gold} \\
 1 \text{ oz. or } 480 \text{ gr.} & \quad \dots \quad \dots = \$20\cdot672 \\
 \$100 & \quad \dots \quad \dots = x \text{ rupees} \\
 x \text{ rupees} & = \text{Rs. } \frac{100 \times 480 \times 240}{18 \times 113\cdot001 \times 20\cdot672} = 273\cdot98
 \end{aligned}$$

2. Find the legal parity value of one tola of gold in India.

$$\begin{aligned}
 1 \text{ rupee} & \quad \dots \quad \dots = 18d. \\
 1,019\frac{1}{2}d. & \quad \dots \quad \dots = 480 \text{ gr. gold} \\
 180 \text{ grains or } 1 \text{ tola} & \quad \dots \quad \dots = x \text{ rupees} \\
 x & = \frac{2039}{2} \times \frac{180}{480} \times \frac{1}{18} = \text{Rs. } 21\cdot239 = \text{Rs. } 21\cdot3\cdot10
 \end{aligned}$$

3. If the cost of transportation from or to London is  $1\frac{13}{80}\%$ , find the import and export parities between Bombay and London.

The legal parity value of one tola of gold being Rs. 21·239 the Government will buy gold at legal parity less the cost of transportation.

$$\begin{aligned}
 \text{It must therefore buy at Rs. } \frac{21\cdot239 \times 100}{101\frac{13}{80}} & = \text{Rs. } \frac{21\cdot239 \times 8000}{6095} \\
 & = \text{Rs. } 20\cdot15\cdot11.
 \end{aligned}$$

$$\begin{aligned}
 \text{The import point into India is therefore } \frac{18 \times 21\cdot239}{21\cdot239 \times \frac{8000}{6095}} d. \\
 = 18 \times 8093 / 8000 = 18\frac{1}{4}d.
 \end{aligned}$$

$$\begin{aligned}
 \text{The Government will sell gold for delivery in London at a price} \\
 \text{equal to Rs. } 21\cdot239 \text{ plus the cost of transportation} \\
 = \text{Rs. } 21\cdot239 \times 1\cdot01\frac{13}{80} = \text{Rs. } 21\cdot239 \times 8093 / 8000 \\
 = \text{Rs. } 21\cdot486 = \text{Rs. } 21\cdot7\cdot9.
 \end{aligned}$$

$$\begin{aligned}
 \text{The export point for India should, therefore, be d. } \frac{18 \times 21\cdot239 \times 8000}{21\cdot239 \times 8093} \\
 = \text{d. } \frac{18 \times 8000}{8093} \quad \text{But, as the Bank of England will buy gold} \\
 \text{only at } 1018d. \text{ per oz., the Government's selling rate for} \\
 \text{sterling should allow for the difference between } 1018d. \text{ and} \\
 1019\frac{1}{2}d. \text{ and will be d. } \frac{18 \times 8000 \times 1018}{8093 \times 1019\frac{1}{2}} = \text{d. } 17\frac{1}{4}d.
 \end{aligned}$$

4. The cost of importing gold from Berlin to London is .4%. If the mint par between London and Berlin is 20·43 find the gold points for Berlin.

$$.4\% \text{ of } 20\cdot43 \text{ is } \cdot0817 \text{ or } \cdot08\frac{1}{4}$$

$$\text{The export point from Berlin is } 20\cdot43 - \cdot08\frac{1}{4} = 20\cdot34\frac{1}{4} \text{ or } 20\cdot34\frac{1}{2}$$

The import point into Berlin is  $20.43 + .08\frac{3}{16} = 20.51\frac{3}{16}$  or  $20.51\frac{1}{4}$   
(In practice, there would be somewhat wider differences).

5. If the rate of exchange on London is  $1/5\frac{1}{8}$  in Bombay, find the import parity of gold costing 84/11 in London.

84/11 is 1019*d.* and the cost in India will be  $\frac{1019 \times 8093}{8000}$  *d. per oz.*

or  $1019 \times \frac{8093}{8000} \times \frac{3}{8}$  *d. per tola*

or Rs.  $\frac{1019 \times 8093 \times 3 \times 8}{8000 \times 8 \times 143} = \text{Rs. } 21-10-0$

6. If T.T. on London is  $1/5\frac{1}{8}$  what should be the price of gold in Bombay so that it could be exported to London?

Gold sent to London can be sold at 84/10 $\frac{1}{2}$  or 1018 $\frac{1}{2}$  *d.*

It should therefore be available in India at

*d.*  $1018\frac{1}{2} \times 8000/8093$  per oz. or

*d.*  $1018\frac{1}{2} \times \frac{8000}{8093} \times \frac{3}{8}$  per tola or

Rs.  $1018\frac{1}{2} \times \frac{8000}{8093} \times \frac{3}{8} \times \frac{1}{14}$  per tola or

Rs. 21-4-4 per tola.

7. If T.T. on London is  $1/5\frac{1}{8}$  what is the imported cost per tola of gold in Bombay with expenses at  $1\frac{3}{8}\%$  when gold in London is 85/1 per ounce?

$x$  Rs. .. = 1 tola

8 tolas .. = 3 oz.

1 oz. Bombay =  $\frac{8093}{8000}$  oz. London

1 oz. London = 1021*d.*

$17\frac{1}{8}$  or  $\frac{137}{8}$  *d.* = 1 Re.

$x = \frac{1}{8} \times \frac{8093}{8000} \times 1021 \times \frac{16}{287} = \text{Rs. } 21.593 = \text{Rs. } 21-9-6.$

8. If T.T. London on New York is 350 (in 1921) and Bombay on London is  $1/3\frac{1}{2}$  what should be the price of gold in India to permit export to New York, the transportation cost being 2%?

If  $x$  rupees is the legal parity value between Bombay and New York for one tola of gold,

$x$  rupees .. = 1 tola gold

8 tolas .. = 3 oz.

1 oz. .. = \$20.672

\$3.50 .. = 10*d.* or 1*£*

$15\frac{1}{2}$  *d.* .. = 1 rupee

$x = \frac{3 \times 20.672 \times 240}{8 \times 3.50 \times 15\frac{1}{2}}$  .. = Rs.  $\frac{20.672 \times 360}{7 \times 31}$

The export parity is = Rs.  $\frac{20.672 \times 360}{7 \times 31} \times \frac{100}{102}$   
= Rs. 32-9-6.

If £1 worth of gold equals grammes 7.3223 find the value at mint par of one gramme gold in Switzerland and also at 25.15 exchange.

7.3223 grammes gold = 25.22 Sw. frs.

1 gramme gold .. =  $\frac{25.22}{7.3223}$  Sw. frs. = 3.4443 Sw. frs.

At exchange 25.15 the value is  $\frac{3.4443 \times 25.15}{25.22}$   
= 3.437 Sw. frs.

10. When gold in India is selling at Rs. 21-7, an importer orders gold from Durban at 84*sh.* per fine ounce to the value of £10,000. If T.T. on London is 1/5½ and expenses amount to 1%, what is the profit on the transaction?

£10,000 will give  $\pounds \frac{10000 \times 20}{84}$  ounces or  $\frac{10000 \times 20}{84} \times \frac{3}{8}$  tolas or  
 $10,000 \times \frac{20}{84} \times \frac{3}{8} \times 21\frac{7}{8}$  Rs. = Rs. 1,36,111 nearly.

£10,000 at 1/5½ =  $\frac{10000 \times 240 \times 8}{143}$  = Rs. 1,34,266

Adding 1% cost of transportation = Rs. 1,34,266 + 1,343  
 = Rs. 1,35,609

Profit on the transaction equals Rs. 1,36,111 - Rs. 1,35,609  
 = Rs. 502.

11. A bank in London sends gold to Belgium, the cost of movement being ¼%. If the London rate on Brussels is 34·85 what is the profit on shipping 2,000 oz. at £4-4-10½?

The mint par between London and Brussels is 35 belgas per £  
 By shipping 1£ worth of gold one can receive 35·00 belgas  
 less cost of sending, i.e., 35·00 - ¼ = 34·86 belgas  
 By selling 34·85 belgas he will get back his 1£ and there will  
 be a profit of 0·01 belga per £ worth of gold.

2,000 oz. = £4-4-10½ × 2,000 = £8,487½ and the profit is  
 84·875 belgas =  $\frac{84 \cdot 875}{34 \cdot 85}$  £ = £2-8-8.

12. When silver in London is quoted at 35*d.* and the sterling rate is 1/4, a dealer buys 100 bars of silver and sells at Rs. 90-2-0. What is his profit? (A bar weighs 2,800 tolas).

100 bars = 100 × 2,800 tolas =  $\frac{2800 \times 100 \times 3}{8}$  ounces fine  
 =  $\frac{2,800 \times 100 \times 3 \times 40}{8 \times 37}$  standard ounces

= 2,800 × 100 ×  $\frac{3}{8} \times \frac{40}{37} \times 35*d.*$  = 2,800 × 100 ×  $\frac{3}{8} \times \frac{40}{37} \times \frac{35}{16}$  Rs.

Cost in India = 2,800 × 100 ×  $\frac{3}{8} \times \frac{40}{37} \times \frac{35}{16} \times 1 \cdot 0125$  Rs.  
 = Rs. 2,51,415

Proceeds of sale = Rs. 2,800 × 100 ×  $\frac{90\frac{1}{2}}{100}$  = Rs. 2,52,350  
 and profit = Rs. 2,52,350 - 2,51,415 = Rs. 935.

13. Silver in London being quoted at 12½*d.* and T.T. on London being 1/5½, an importer brings in 250 bars of silver and sells them at Rs. 43-0-0 per 100 tolas after paying duty of 6*as.* per ounce. What is his profit?

The price of the silver in Bombay is

$250 \times 2,800 \times \frac{3}{8} \times \frac{40}{37} \times \frac{35}{16} \times 1 \cdot 0125$  Rs. = Rs. 2,01,117.

Duty on  $250 \times 2,800 \times \frac{3}{8}$  oz. is  $250 \times 2,800 \times \frac{3}{8} \times \frac{3}{8}$  Rs. = Rs. 98,475

Total cost = Rs. 2,01,117 + 98,475 = Rs. 2,99,592.

Sale proceeds = Rs.  $250 \times 2,800 \times \frac{43}{100}$  = Rs. 3,01,000.

Profit on the deal = Rs. 3,01,000 - 2,99,592 = Rs. 1,408.

14. A banker buys 10,000 oz. gold in London at £4-4-11 and sends it on to New York when the rate is 484½. What is his profit, taking cost of moving the gold at .4%?

The cost of 10,000 oz. = £4-4-11 × 10,000 = £42,458-6-8

The cost of transportation = .4% of £42,458-6-8 = £ 169-16-8

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£42,628-3-4

10\$ will contain 232.2 grains pure gold or \$1.00 = 23.22 gr.

∴ 10,000 oz. =  $\frac{10,000 \times 480}{23.22}$  = £  $\frac{10,000 \times 480}{23.22 \times 4.84\frac{1}{2}}$

=  $\frac{4,800,000 \times 400}{23.22 \times 1937}$  £ = £42,688-7-0.

Profit = £42,688-7-0 - £42,628-3-4 = £60-3-8.

## CHAPTER XXX.

### COUNCIL BILLS AND REMITTANCES.

*"Ring out the old, ring in the new"*

Stages in Indian exchange policy—Council Bills—Reverse Councils—The 1923 experiment—The sterling tenders—Treasury Bills—Remittances through the Reserve Bank.

The history of the control of the foreign exchanges of India may be divided into three stages. The first is the stage in which the rupee had only bullion value and was freely minted by the Government. During this period the external value of the rupee varied with the gold price of silver. In the second stage following the closing of the mints in 1893, it became the duty of the Government to interfere in maintaining the value of the token coin at or near the value fixed by it. This led to a double responsibility which soon became the foundation of the monetary system. This responsibility was to acquire the surplus sterling balances of the exporters from the hands of the banks and issue rupees against them, which would, of course, prevent the exchange rate from moving too high. It so happened that the annual surplus was nearly equal to the demands of the Secretary of State for 'Home Charges,' interest, and capital expenditure to the extent to which it was met out of Indian funds. The problem of the Secretary of State having to buy unwanted sterling

thus did not arise but there was the difficulty that, in regard to its commitments in London, the Government was leading a hand-to-mouth life, and the Secretary of State had to depend for his funds on the monsoon in India. If it was bad, the exports were low and the Secretary of State had to resort to borrowing in London hoping that the loan could be repaid next year. But, as the revenues of the previous year had fallen owing to crop failure, the Government rarely found the money with which to buy the surplus sterling of the year even if it materialises. The second responsibility was that, if imports exceeded exports heavily and depressed the exchange rate, the Secretary of State would have had to sell his sterling balances to satisfy the requirements of Indian importers and receive the rupees in India, thus contracting currency and influencing the exchange rate to become steadier. But such contraction of currency could not go on to any substantial extent and there was also the fact that the Secretary of State did not usually have the sterling funds to dispose of. Nor did the sale of sterling result in a corresponding contraction of currency in India, though it sometimes did.\*

The process by which the funds were transferred from India to London or from London to India may be described in some detail though it is now only of historical interest. The Secretary of State for India would sell what were known as 'Council Bills', presumably so called because they were supposed to be issued by the India Council. These bills were drawn on the Government of India and were the equivalents of demand drafts on India. Tenders were received every week for their sales and the banks in India who had bought too much sterling instructed their London offices to make the tenders and if the rates were suitable, the Secretary of State allotted his sales among them. Tenders were also made by the big commercial firms. If the amount did not come up to his requirements, the Secretary of State had to be satisfied with what he got. The Council Bills were then remitted to India by the banks and presented to the Government of India

\* B. E. Dadachanji—Indian Currency and Exchange, page 148.

at its pay-offices in Bombay, Calcutta or Madras as desired. The Secretary of State also undertook to make the payments by cable but in this case the banks had to pay  $\frac{1}{2}d.$  more per rupee to compensate the Government for the earlier payment in India than in the case of the ordinary Council Bills. If the banks desired to buy Council Bills between two sales they were allowed to do so at an "intermediate" rate which was usually  $\frac{1}{2}d.$  higher than the open rate of the previous week.

The occasions on which Reverse Councils were sold were few and far between as the strength of the rupee continued to grow year by year until the rate which had been officially fixed at fifteen pence had to be raised to sixteen pence where it remained for nearly eighteen years, until it was disorganised by the war. When he did sell Reverse Councils, the Secretary of State paid out his London balances against payment of the rupees in India. These payments were usually made by cable. The Government successfully sold Reverse Councils in 1908, in 1914-1916 and in 1919-1920 when the exchange rate remained below the official rate. In 1920 more than £55 millions sterling was sold at varying rates, but this could not prevent the rate moving down and when it did move the Government had to spread its hands and pray to God that something would happen. Something did happen and that was that the rate fell down to  $1/3\frac{1}{2}$  in terms of a depreciated pound so that the actual gold value of the rupee was as low as  $10\frac{1}{2}$  pence gold in March 1921. On the whole, however, the system worked so well that India was pointed out as the justification of the gold exchange standard and other countries were encouraged to adopt it as an alternative to the real gold standard.

Mr. S. E. Thomas in his "Principles and Arithmetic of Foreign Exchange" says :—

Consequently, if the balance of indebtedness remained against India and the supply of remittances by the State was exhausted, gold for export could not be obtained and the rupee necessarily fell to its intrinsic value as silver bullion. This is what actually happened after the War in spite of the Government's praiseworthy efforts to check the depreciation.

Mr. Thomas doubtless had to be guided by official reports



but, as a student of exchange, he could have seen that practically no country emerged from the war with a currency stronger than before, particularly if it had foreign obligations to look after. Secondly, the exchange rate had gone up during the war from 16 pence to nearly 28 pence, primarily due to the scarcity of silver, and it should have been expected that the rate would go back again as soon as the artificial forces were withdrawn. The Reverse Councils which were contracting the over-issue of currency would throw the silver rupees and notes back on the Government and the redundancy thus created would be a bearish factor in the silver market, and observers had foretold that, with the expiry of the Pitman Act in the United States, the heavy production of the American mines would come on the market. If the rupee was really linked to silver, the Government should never have attempted to block the current where it was strongest. If the Government had waited only one year, the £55 millions which contracted a certain volume of currency could have been used to contract the same amount and leave a surplus of £20 millions as gold assets. It could not be said that this was wisdom after the event because the warning was clearly given by Sir (then Mr.) Dadiba Dalal of the Babington-Smith Committee.\* At any rate this proves that the monopoly of wisdom in such matters is certainly not with the advisers of the Government and that, Indian economists and thinkers deserve more recognition than they have been receiving so far from the authorities.

It is incorrect to say that the gold in India is not available for export to counterbalance the influence of the adverse trade balance ; for when the rate did move so low that gold exports were profitable we have seen that the country exported about 55 crores of gold and it was this more than anything else that stayed the movement in the rate. Again, in September 1931, more than two crores worth was exported in one week.

Lastly, though the rupee was apparently linked with silver, it was not really so. This will be borne out by the following figures showing the silver price, the bullion value of the

\* His exact words were :—"India's trade balances will become less favourable to her than they have been or it may be that the trade balances will turn against her."

rupee in terms of the depreciated sterling pound, and the average exchange rates for the period :—

*Table 13—Silver prices and exchange rates in 1920—1924.*

Year.	Month.		Silver price in London.	Bullion value of the rupee.	Excha- rate.
1920	Jan.	..	85	31 $\frac{1}{2}$	27 $\frac{1}{2}$
	Feb.	..	83	30 $\frac{3}{4}$	27 $\frac{1}{4}$
	Aug.	..	62	23 $\frac{7}{8}$	22 $\frac{1}{2}$
	Nov.	..	40	14 $\frac{1}{2}$	19
1921	Jan.	..	40	14 $\frac{1}{2}$	17 $\frac{1}{2}$
	Mar.	..	33	12 $\frac{1}{2}$	16 $\frac{1}{2}$
	July	..	38	14 $\frac{1}{2}$	15 $\frac{5}{8}$
	Aug.	..	37	13 $\frac{3}{4}$	15 $\frac{1}{2}$
	Dec.	..	36	13 $\frac{1}{2}$	15 $\frac{1}{2}$
1922	Jan.	..	35	13 $\frac{1}{2}$	15 $\frac{1}{2}$
	Aug.	..	34	12 $\frac{1}{2}$	15 $\frac{1}{2}$
1923	Jan.	..	32	11 $\frac{2}{3}$	16 $\frac{1}{3}$
	Aug.	..	31	11 $\frac{1}{2}$	16 $\frac{1}{2}$
1924	Feb.	..	33	12 $\frac{1}{2}$	17 $\frac{1}{2}$

If any inference can be drawn from these abnormal movements, it rather seems to be in favour of the “no-changers,” that there was a ‘natural’ exchange level of 16 pence to which the rate moved and the momentum of the fall from 28 pence in twelve months carried it a little too far, so that the rate rebounded and when the Government began to ‘manage’ the rate, it moved up above that level.

On the other hand, if the price of the rupee tended to its bullion value, we should expect to find that, during the period of free movement of exchange rate, the price of silver in rupees in the Bombay market should be fairly constant as it is in terms of the Shanghai tael. But, the following silver prices (in rupees and annas per 100 tolas) between 1920 and 1924 would show that this was not so :—

*Table 14—Silver prices in India in 1920-24, per 100 tolas.*

	January.	March.	May.	July.	September.	November.
1920	115 0	112 14	104 13	99 9	108 9	110 6
1921	97 4	88 0	90 11	99 15	95 0	97 1
1922	91 0	90 0	94 14	93 2	92 10	84 15
1923	81 12	82 0	84 11	79 1	81 1	79 9
1924	79 12	82 1	81 2	81 9	80 12	75 15

We now come to the third stage, when it was decided in 1923 to try the experiment of the Government of India remit-

ting instead of the Secretary of State drawing. The latter could not always know the state of the Indian sterling markets as well as the former. While the result was the same as before for the Secretary of State, for the Government of India there was a double gain. It did away with the inferiority-complex due to the control of Whitehall and it left the choice of the time and manner of remittance to be made according to the state of its balances with the Imperial Bank of India and the condition of the money and exchange markets. According to this plan, £8.75 millions was sold in London in 1923, against £13 millions bought in India. In 1924, Council Bills were £7.5 millions against £33 millions remitted and in 1925 it was decided to transfer the business entirely to India as the success of the remittance plan justified the change.

The transfer of the responsibility for the remittance also transferred the responsibility to maintain the exchange rate. From 1926 the Government undertook that in years of surplus exports it would buy sterling in any amounts above the upper point which was fixed at  $18\frac{3}{4}d.$  and when the rate went down to  $17\frac{4}{8}d.$  the Government undertook to supply any amounts of sterling at that rate. When the latter promise was called for in 1930 and 1931 it was found that the sterling resources in the Paper Currency Reserve had been exhausted, and sterling had to be borrowed in London, heavy transfers made between the Paper Currency and Gold Standard Reserves, as also currency contracted by substitution of Treasury Bills in the Paper Currency Reserve by Bills sold to the public.

When the Government now desires to purchase sterling, it calls for tenders and states the amount to be tendered for. The Controller of Currency, after scrutinising the tenders, decides whether the rate is justified by market conditions and if so, allots to each bank in proportion to the amount applied for, if the total exceeded the Government's requirements. It sometimes happens that the banks tender at different rates as they could not afford to sell all the amount at the higher rate. Thus, if the banks wanted to secure a net rate between  $1/6\frac{1}{8}$  and  $1/6\frac{1}{16}$  they might tender for £800,000 at the former rate and £1,200,000 at the latter or if they wanted a rate some-

what better, the tender might be £1,200,000 at the former and £800,000 at the latter rate. The Controller of Currency then accepts as much as he wants at the higher rate of  $1/6 \frac{1}{8}$  and if he still wants to buy, he buys some more at  $1/6 \frac{1}{2}$ . But before allotting at the lower rate he would naturally use up all the tenders at the higher rate.

As in the case of Council Bills, the purchases are made at weekly intervals and tenders accepted every Tuesday. Between one week and another if banks are eager to sell to the Government, they are allowed to do so at a rate  $\frac{1}{8} d.$  higher than the best rate of the last week's tenders. This rate is generally known as the intermediate rate. It sometimes happens that the Government of India is short of ready money as the Ways and Means position shows. Its balances with the Imperial Bank of India would not permit the payments for the sterling purchases. It then resorts to the issue of Treasury Bills with a maturity of three months, which it expects to repay out of revenues collected later in the year. As a good proportion of the Treasury Bills are bought by the exchange banks this is often equivalent to borrowing from them ready sterling with a promise to pay for it at a later date and, in the meantime, the formal payment is made in India by borrowing from them. As such a loan cannot be made without some profit to the exchange banks, it becomes necessary to accept tenders for Treasury Bills at a rate higher than the market warrants. The correctness of this explanation will be tested by the rate at which the Government will be able to issue Treasury Bills after the establishment of the Reserve Bank. If the theory is right, the Treasury Bills would be issued at or below market rate for three months funds, as the Government would borrow sterling from the Reserve Bank and issue Treasury Bills to the banks and the public.

In normal times the purchase of sterling means the issue of further currency and as the sterling is generally bought in the export season, the supply of currency in the market is welcome. But when the purchase is paid for by money borrowed immediately, the market stands where it was, resulting in further tightness. On the other hand, if the Government

should not buy at regular intervals the banks would be unable to continue their purchases of export bills from the public as they could not be sure that they could sell the sterling against them to the Government.

The Government has three methods of placing the Secretary of State in funds. As exchange authority it may have acquired in previous years substantial sterling balances which it could now use for its own purposes, rather than leave them as possible reserve against depreciation of the exchange rate in future years. It could buy sterling in the open market as described above. Thirdly, it could borrow in London, hoping for better times. These are just the same options as were available to the Secretary of State when he managed to provide himself with funds and are subject to the same limitations. There is one defect arising out of this that the public cannot always know whether the Government operations arise out of currency, or exchange purposes or are for the Government's own account.

With the establishment of the Reserve Bank this anomalous condition will disappear and the Government will borrow in the London market for its own operations, chiefly, to meet its capital requirements. The currency and exchange needs would be looked after by the Reserve Bank and the requirements of the Government's sterling remittances which would be entrusted to it would be arranged for by it according to its judgment of the state of the exchange market. It may lend to the Government out of its own funds but it cannot charge any interest for it, as it would receive the rupees in India, which it would be the business of the Government to find from its Ways and Means position. The Reserve Bank may make the purchases by tenders or at its discretion from the banks, though such a policy would be subject to criticism from the banks themselves. In view of the peculiar conditions in India it might be just as well for the Reserve Bank to deal in an open manner and without giving room for complaints regarding discrimination.

1. A bank tenders for £30,000 at 1/6 and £70,000 at 1/5 $\frac{1}{2}$ . The Controller of Currency accepts the first quotation and allots 13% on

the second one. What is the sterling amount it should pay and what is the rupee amount it will receive? If it has bought the sterling at  $1/6\frac{1}{32}$ , what is the profit on the transaction?

It is allotted £30,000 at $1/6$ ..	Rs. 4,00,000 0 0
It is allotted 13% of £70,000 or	
£9100 at $1/5\frac{31}{32}$ .. ..	Rs. 1,21,544 5 6
The allotment is £39,100 .. ..	Rs. 5,21,544 5 6
The cost of £39,100 at $1/6\frac{1}{32}$ ..	Rs. 5,20,429 12 8
Profit on the transaction is ..	Rs. 1,114 8 10

2. A bank tenders for £70,000 at  $1/5\frac{31}{32}$  and is allotted  $11\frac{1}{2}\%$ . If it has bought £5,000 of it at  $1/6$  and the rest at  $1/6\frac{1}{32}$  what is its profit on the transaction?

The allotment is $11\frac{1}{2}\%$ of £70,000	£8,050
£8,050 at $1/5\frac{31}{32}$ .. ..	Rs. 1,07,520 0 0
Value of £5,000 at $1/6$ .. ..	Rs. 66,666 10 8
Value of £3,050 at $1/6\frac{1}{32}$ ..	Rs. 40,596 2 10

The cost is	= Rs. 1,07,262 13 6
The profit is	= Rs. 257 2 6

## SECTION III.

### CHAPTER XXXI.

### THE GOLD STANDARD.\*

*"The worship of the golden calf"*

The old gold standard—The new one—Gold bullion standard  
—Partial gold standard—Fixed issue—Proportional issue—  
Postwar expansion of note issue—Secondary expansion—Means  
of steadying exchanges.

England was the first country to adopt the full gold standard. It will be a matter of surprise to some accustomed to regard the United States as the premier gold standard country, to know that it was, at one time, just after the "Civil War", one of the paper standard countries owing to the large volume of its "greenbacks". The gold standard as adopted in England postulated three conditions:—

1. A free market for gold
2. Free circulation of gold coins
3. Convertibility of notes into gold coin on demand

It was considered that the chief and most essential condition was the second. The free circulation of gold coins, therefore, became an article of faith of most people and even today the idea persists. Its value lies in the fact that, whenever the balance of payments was against the country, gold could be exported and the exchanges restored. We have seen, however, that this was necessary only when other means of remittance such as cable transfers and demand drafts became more costly than the cost of sending the gold itself.

The war worked havoc with this idea. Most Governments were faced with enormous expenses for equipment and supplies for the forces and the only way to meet them was to issue notes on the authority of the State, without the gold backing till then required. These notes very soon became inconvertible and it was deemed necessary to prohibit free movements of

\* Part of this chapter is based on articles by the author in the "Indian Finance."

gold in almost all countries. In England, all stocks of gold, more than fifteen days old, had to be tendered to the Bank of England at its statutory buying rate, which meant a loss of 10 to 15%, as the pound was then worth only about \$4·25. All the coins thus came into the vaults of the Bank of England and its gold holdings increased from £40 millions to £160 millions in this period. Similar events happened in other countries so that there is now no gold standard country to judge by the prewar test of coin circulation.

The extent of this concentration may be seen from the fact that, in 1913, the Central Banks of the world had a total gold holding of £1,000 millions against £785 millions of coins in circulation, and in 1928 it was £2,070 millions against £190 millions. When the currencies returned to gold, the success with which gold coins had been replaced by representative note issue created a new tradition that gold was not as necessary for internal circulation as for the purposes of foreign trade and the most convenient form in which a nation could hold the gold was in the vaults of the Central Bank from which exporters of gold could obtain it with the least possible delay.

A free market for gold means that there should be no restriction on the movements of gold, either legal or exercised by other means. Thus, the Bank of France had the power, before the war, to cash its notes either in gold or silver at its option. Even now its rates for buying and selling gold are fixed from time to time in consultation with the Minister of Finance. Imports into countries without sufficient gold resources are welcome, but exports are frowned upon. This, however, is a factor against the accumulation of gold there, because people will be afraid that it is a sort of "land from which there is no return". Where the gold reserves are strong, the gold that comes into the market is bought and sold like all other commodities. Even in London there is some kind of moral embargo as the Bank of England would make enquiries about the purpose of requests for gold and we have seen that, during the period after the war there was also a legal embargo, which often resulted in gold being sold at import parity into New York.



While such embargo on gold export is possible, an embargo on imports of gold does not seem likely to exist. But there were at least two such countries, Sweden and Switzerland. In the former, as Prof. Gustav Cassel wrote, the country "went through a most violent economic crisis which annihilated the fortunes of a great many people, exposed the banks to serious difficulties and for a time paralysed the industry of the country", in order to return to the gold standard. A gold influx would have created a disturbance of price levels by inflating currency. So, between 1921 and 1929, the Riksbank would not issue local currency against tenders of gold and thus preserved the benefits of the return to gold accomplished with such heavy sacrifices. In the latter, which has remained on the gold standard almost all through, the currency system had to be reorganised, chiefly due to the arrival of the Bank for International Settlements in Basle. The Swiss National Bank has the option of issuing local currency or foreign currency against tenders of gold and this is, perhaps, as much a protection against the transactions of the B. I. S. as against ordinary customers.

In the prewar days an import of gold was of no practical value unless it could be minted into coins and used as legal tender. Hence, the provision of mints for the coining of gold became a function of the State. Similarly, if gold were exported to another country, it would have to be tendered to the Central Bank there, for being converted into legal tender coins of that country. The war-time economy in the use of gold has taught that the settlement of foreign payments could just as well be made through shipments of gold bullion which could be made available to exporters in bars of about 400 oz. worth about £1,700 or Rs. 22,500. In other words, the man in the street was kept out of the possibility of tendering his single note and asking for its redemption in gold, which was thus limited to its requirements for international trade. So long as people knew that the notes were redeemable in gold in large quantities so that their external value was constant, the paper money was just as good for internal use with the advantage that it was more easily portable.

The currency authority was thus burdened with the duty

of preserving the external value of the currency unit by manipulating the various factors regulating the exchange rates. To the methods by which such manipulation is made we shall revert later. The effect of the gold bullion standard is to give the exporter certain advantages which he did not have under the "full" or automatic gold standard. In the first place, the melting of exported coins in another country and then recoin-ing is avoided. For the gold bars would now be kept in the other Central Bank in the same bullion form, and notes issued against them, which are just as satisfactory to the public there as the notes in the exporting country. The gold export has contracted the note issue in just the same way as the export of gold coins contracted the volume of currency in the prewar days, and the exchanges moved in just the same way. There is thus created a gain to the exporter of gold in the matter of minting charges and the interest for the time taken to mint.

Another gain for the exporter arises from the fact that in the case of the gold currency standard, he had to be content to receive gold coins in exchange for his notes so long as they were legal tender weight. Thus, even the Bank of England is authorised to pay out gold coins of the standard fineness but with a weight not less than 122.5 grains though the official weight of the sovereign was 123.274 grains. This would have involved the exporter in an average loss of  $\frac{1}{2}\%$  for which he had to compensate himself by charging a higher price for the foreign currency acquired. The bullion standard eliminates this loss to the exporter.

To the nations themselves there is an additional advantage. The gold currency standard, by insisting on the coins being in circulation, incurred the risk of their being buried or lost, while now it is only paper that is lost and the Central Bank could, without any difficulty or loss to it, issue new notes instead, if it was satisfied that the loss was real. Then again, coins in use are subject to depreciation through abrasion and sweating. The amount of such loss in prewar days is estimated at 0.2% per annum, but the gold bullion in the vaults of the Central Banks remains intact so that the nations gain nearly 0.2% every year by storing the gold properly.

While the prewar automatic standard forced the hands of the Central Banks to follow the movements of gold in their issue of local currency, the postwar theory and practice has been that an influx of gold is not always accompanied by a change in the volume of currency. Gold is thus no longer a medium of exchange but merely the basis for the actual medium of exchange which is the currency note. The prewar gold standard by insisting on gold as money made the note a luxury or a matter of convenience in making large payments, but the postwar standard has made gold coins a luxury and the note or the representative token currency the standard of money. The result is that the movements that would have resulted from the free circulation of gold coins have been prevented by Central Bank control of the note issue independently of the volume of the gold reserves.

The economy in the use of gold in the postwar currency has made it possible for Central Banks to increase their note issues far more than would have been possible under the automatic standard of the prewar days. The following table gives the gold holdings and note issues of some important countries in the two periods:—

*Table 15—Gold holdings and note issue of Central Banks  
1913 and 1931.*

Name of country. (in millions of £).	1913		1931		
	Gold.	Notes.	Gold assets	of which gold	Notes.
* England	... 40	29	140	140	347
United States*	... 377	501	661	661	494
France	... 164	236	658	448	634
Germany	... 63	94	120	110	236
Japan	... 22	31	83	83	121
Italy	... 44	66	122	76	164
Holland	... 13	26	57	36	67
Belgium	... 10	64	65	39	91
<b>Total</b>	<b>... 733</b>	<b>1047</b>	<b>1906</b>	<b>1593</b>	<b>2154</b>

\* The note circulation of the United States includes only Federal Reserve Notes.

The gold holdings have increased only by £860 millions but the note issue has increased £1,107 millions. Part of the new gold is gold coins from circulation and part purchased by the Central Banks from fresh production.

The next step in the process of conservation of gold supplies would be to avoid the actual exports of gold. Apart from the expenses on account of freight, interest etc., there is a greater international interest in the matter. If the gold should be lost as in the case of the "Egypt" disaster, the insurers and underwriters could repay the shippers in notes, but they could not repay the gold which had been lost. In spite of several years' efforts, it has not been possible to effect the salvage of the "Egypt" gold even though its exact location is known. The world, therefore, stands in the same position as a labourer who receives compensation for a limb which he lost in a factory, but the compensation is not the limb itself. It has, therefore, been suggested that Central Banks should not move the gold about from one country to another, but should hold the gold as "ear-marked" for account of the Central Banks which would have received it, had it been moved. Parties who now import gold into a country would then tender the right to gold to the Central Bank and receive local currency in exchange at a price which would be the equivalent of the imported gold. The Central Bank would later issue orders on this "earmarked" gold when it is necessary to export gold from the country, and it would charge a price equal to the value of the gold in the country plus transportation charges. Should the condition of the trade between the countries indicate that the resale of gold is not likely, the gold might be actually shipped.

Central Banks would probably find that the earmarking means leaving the gold in the hands of the other Banks without the compensation of interest. They might, therefore, invest them in earning assets, which brings about the partial gold standard. This has led to the statutes of most of them being amended to permit the keeping of a certain proportion of the gold assets in foreign centres. It should be one of the cardinal doctrines of Central Banks that this earmarked gold or foreign assets shall be treated as sacred and not subject to the risks of

confiscation or segregation in times of war. An international convention to this effect would go a long way to reduce the volume of gold movements.

The issue of notes under the gold standard is worked on two principles. The first is the fixed issue system adopted in England, whereby the Bank of England is authorised to issue a specified volume of uncovered or "fiduciary" notes and every note issued over that limit has to be backed by an equal volume of gold in the vaults of the Bank. This means that the regulation of internal currency to meet the seasonal demands of trade is not possible, but England is so accustomed to paying by cheques that currency need not be increased in the busy season, and all that is required is that the member banks should work on a smaller reserve of bank cash. The uncovered note issue of the Bank of England in 1913 was £18½ millions but it had to take up the huge volume of Treasury Notes issued during the war and after, and in 1928 it was authorised to have an uncovered issue of £260,000,000 and a further issue of £5,000,000 against silver and copper coins. The total volume of currency in England is about £400 millions as against the prewar issue of about £30 millions notes and £130 millions of gold coins.

The second is the proportional system introduced in the United States in 1913 when the Federal Reserve Banks were started. According to this system, which has now been adopted in almost all countries, the Central Bank is authorised to issue notes and incur sight and demand liabilities up to a maximum limit of  $2\frac{1}{2}$  times its gold assets. Some banks have adopted a somewhat higher ratio and some a lower ratio. The actual gold reserve of the Banks would, however, be between 45 and 50%. Sometimes the notes are issued unit for unit and the ratio of gold is thus raised. When the trade demand is brisk, this system enables the Bank to rediscount bills which would be redeemed when the demand slackened, and for this period the Central Bank works on a lower gold reserve ratio.

In the United States there is another provision for seasonal expansion of currency. The Federal Reserve Banks would

issue their own notes of 40% reserve or the gold certificates with full gold backing. The first series would allow the volume of currency to be increased without an increase in gold assets, provided there were enough gold certificates to be withdrawn against Federal Reserve notes. Again, if there is contraction to be made, provided there are enough Federal Reserve notes, they could be substituted by gold certificates. Moreover, when there are gold imports and the Federal Reserve Banks do not want to increase currency, gold certificates would be issued to contract currency so that the issue against the gold would be offset by the contraction.

The proportional system now adopted in practice calls for more active interference by the Central Banks and expert "management". The changes from the old days are thus described by Mr. W. A. Brown Jr. in his "England and the New Gold Standard":—

"If, on the other hand, the international Central Bank co-operation of the postwar years can be preserved and the modern world can emancipate itself from the spell so long cast upon the minds of men for gold, the new gold standard will become a fact. It will mark a definite advance over the gold standard of 1914 in three very important respects. First, it will recognise that the use of gold as currency can be permanently dispensed with without injury to the purpose for which the gold standard exists. Secondly, it will frankly regard as insufficient the mere establishment of a common international standard of value and the binding of the world together in one common price system, and will consider as part of its essential functions the effort to maintain general stability in that common price system over long periods as well as short. And, third, it will emancipate itself from rigid arithmetical ideas as to the ratio of gold necessary in gold standard countries. A more rational use of gold than was possible before the rich experience of postwar years widened men's outlook on the whole question of monetary standards is the heart of what has been called in these pages the new gold standard".

In the case of countries on the fixed issue system, an export of gold means an automatic contraction of an equal volume of currency but the moral effect is that the gold reserve becomes lower than in other countries. Thus, if in England, £140 millions of gold is the reserve against £260 millions of fiduciary notes and £140 millions of covered issue, the gold reserve is 35%. If £20 millions gold is exported, the reserve becomes £120 millions against £380 millions of notes or 31·6%.

When there is an import of gold of £20 millions, this would mean a reserve of £160 millions against £420 millions of notes or a reserve of 38·1%. But in the case of a country on the proportional system, if the reserve is 80 crores against 160 crores of notes and 20 crores is exported, the contraction of note issue would not be only 20 crores but about 40 crores so that the reserve would be 60 crores against 120 crores or 50% as before. But an increase of gold would not be followed by an increase of double the volume of notes, and so the reserve would be increased to a higher percentage. Hence the moral effect of an export of gold is far greater in countries like England than in countries like France and Germany, while the effect of an influx of gold would probably be the same in all of them.

Some Central Banks have the option of delivering gold or gold exchange and such countries are said to be on the partial gold standard and countries which will only deliver gold exchange are called gold exchange standard countries. Most countries have to clear their international obligations through either sterling or dollars and it has become necessary for them to keep foreign balances for the purpose. These give immediate delivery of the foreign currency, while an export of gold will involve the time element, which, in the case of countries like India and Japan, might well be a deciding factor in favour of the exchange deliveries, as the transit time to the nearest gold centre is fifteen to thirty days. Today, all the Central Banks, except the Bank of England and the Federal Reserve Banks, maintain foreign balances, the size of which will be seen from the following table compiled from the Bulletin of Statistics issued by the League of Nations, for February 1931 :—

*Table 16—Gold and foreign balances of some Central Banks.*

Name of country.	Currency	Gold	Foreign assets.
	(in millions of local currency units).		
Germany .. ..	Reichsmarks	2285	166
Belgium .. ..	Francs	7081	4558
Austria .. ..	Schillings	214	628
France .. ..	Francs	55924	26285
Italy .. ..	Liras	7086	4037
Holland .. ..	Guilders	446	227
Sweden .. ..	Kroner	240	352
Switzerland .. ..	Francs	643	379

While the holding of such foreign balances or "valuta" or "divisen" as they are called, is an advantage to the Central Bank, it is a source of danger for the Central Bank of the gold centre. In 1930 the foreign currency holdings of the Central Banks in both London and New York amounted to nearly £200 millions in addition to holdings of bills and long-term securities about £200 millions, against which the Central Banks there had a gold reserve of £800 millions for a note issue of £840 millions. It will be clear that any foreign bank could easily precipitate a crisis in these centres if it was so inclined. The bank might ask for the conversion of its gold balances into gold and this menace would exist as long as the balance itself existed. The fact that the gold holding of the Bank of France increased from 18,126 million francs (£145 millions) in December 1927 to 50,807 million francs (£413 millions) in December 1930 shows the extent of the disorganisation it might have caused, if it had been so inclined. It is believed in some quarters that it did use it in making bargains in connection with the settlements about the German Reparations.\*

This danger is greater if the foreign assets are kept without the knowledge of the Central Bank of that centre in the form of commercial bills for, without warning to the Bank, the claims to gold might be presented at an inconvenient time. It would, therefore, be necessary that the foreign assets of Central Banks should be maintained with the Central Bank of that centre, whether in the form of bills or currency.

The fundamental postulate of the partial gold standard is that there should be some centres which are not allowed to hold foreign assets as part of their reserve. Otherwise there might be formed a vicious circle of Central Banks pretending to acquire foreign balances by crediting other Central Banks and all of them might make the foreign assets the basis of

\* Since writing the above, France withdrew £29 millions from London in one fortnight and several aeroplanes were employed to convey one ton of gold in one day, which is a record in several ways. The Bank of England had to raise its discount rate from 2½ per cent. to 4½ per cent. in two successive weeks, a thing which had not happened since 1908. The Bank of France and the Federal Reserve Board lent to the Bank of England £50 millions and the latter also got authority to increase the fiduciary issue by another £15 millions. But this could not prevent the departure from gold in September 1931 to \$3'80 per £.



fresh note issue without any real gold backing. Even if the ideal gold standard countries were in existence, it is possible countries. Thus, if A were the ideal country and B and C two partial standard countries, the following transactions might arise :—

*Table 17—Secondary expansion under partial gold standard.*

			A	B	C
Stage I	Gold	..	40	40	40
	Gold balances	..	—	—	—
	Notes	..	100	100	100
	Other liabilities	..	—	—	—
Stage II	Gold	..	80	20	20
	Gold balances	..	—	20	20
	Notes	..	100	100	100
	Other liabilities	..	40	—	—
Stage III	Gold	..	80	20	20
	Gold balances	..	—	40	40
	Notes	..	100	100	100
	Other liabilities	..	80	20	20
Stage IV	Gold	..	80	20	20
	Gold balances	..	—	40	40
	Notes	..	120	130	130
	Other liabilities	..	80	20	20

Thus, there would be an increase of 100 units of liabilities in the ideal country, based on the 40 units of gold imported, and 100 units in the other two countries based on the foreign balances created by the gold exports, or a total increase of 200 units in them all together, without any increase in the gold holdings. To avoid this danger, it has been suggested that Central Banks should hold foreign assets in the fundamental reserve only to the extent necessary for international payments and, if possible, the whole of these assets should be held in the banking department.\*

In a gold standard country there are four methods open to the Central Bank for regulating the exchange rate. The first is the manipulation of the volume of currency through open

\* The Macmillan Committee on Finance and Industry in England has recommended that the two departments should be worked as one, as the present practice is meaningless and confusing.

market operations, which would moderate the external value of the monetary unit. The second is the raising or lowering of the discount rate, which would regulate the volume of foreign funds in the country and thus create a demand or supply of exchange to influence the rates. This method is sufficiently important to be dealt with in a separate chapter. The third is the raising of loans abroad for purposes of stabilisation. These loans have been rather constantly in use recently and the various Central Banks have co-operated in making these "stabilisation" loans.\* Similarly, repayment of foreign loans of investment abroad would check a rising rate. These remedies have a "forward" effect because the repayment of the loans or the return of the capital would turn the exchanges the other way. The fourth is a more permanent and radical cure by exporting or importing gold and using it as a means to regulate the volume of currency and credit. In the former case, if the demand for bullion persisted, the Central Bank would probably enquire of each applicant for foreign currency the purpose of his request, and might even institute a sort of censorship on exchange demands such as existed in the war and postwar reconstruction period.† It might even, as a last resort, commandeer all the foreign balances and ration them to applicants. This would discourage imports and restrict them so as to balance foreign payments and even turn the tide back again.

## CHAPTER XXXII.

### THE FUTURE OF THE GOLD STANDARD.

*"The old order changeth, yielding place to new"*

Gold production—Monetary demand—Gold shortage—Reserve ratios—Gold reserve and foreign trade—Central Banks and gold prices—The dollar standard—The Indian demand—Gold standard for India.

The problem of the gold standard at present has been narrowed down to finding a certain percentage of gold assets

\* The latest example is the seven-power loan to Germany to enable her to make the "unconditional" Reparations payment of 1931.

† This happened even in India in September 1931 when the Government announced that it would sell Reverse Councils only for genuine trade demands.

to the liabilities of Central Banks so that it would be possible for them to meet the ordinary demands for the metal owing to the influences of balance of foreign payments. This brings into great prominence the supply of gold at present and whether the supply will be sufficient in the future. It is estimated that while the demand of the Central Banks will be increasing year by year, the supply will be decreasing, unless some new sources of gold are discovered. In some countries the mines have been worked so deep that the law of diminishing returns has begun to operate and, in some others, the supply is getting exhausted, and it is only Canada that is expected to increase its yield. The estimated output of the mines is given as follows in the First Interim Report of the Gold Delegation of the League of Nations:

Table 18—Gold Production, 1929-1940.

Country. (in £ millions)	1929 Actual	1930	1935 Estimates	1940
South Africa ..	46.7	43.0	39.2	25.6
Canada ..	8.1	8.4	9.0	9.6
United States ..	9.1	9.4	8.0	7.4
Australia ..	2.5	2.3	2.2	2.1
India ..	1.5	1.6	1.5	1.4
Others ..	15.6	18.7	18.5	18.5
Total ..	83.5	83.4	78.4	64.6

The present gold holdings of the major countries are:—

(in £ millions) *Sight liabilities. 40% cover. Actual gold.*

United States ...	1340	536	803
Britain ...	535	214	144
France ...	700	280	329
Other Countries ...	2565	1030	642
Total ...	5150	2060	1918

There is thus an insufficiency of gold assets for the world on the basis of 40%, but the problem becomes more serious on account of the expected shortage in the supply. Basing his estimate on the amount of currency in 1850 and 1910 when the price levels were the same, Prof. Gustav Cassel thinks that the annual monetary demand is 3% of the circulation

and, therefore, the annual monetary demand for gold would be 3% of existing stocks. Of the £83.5 millions of annual output £45 millions only is available for monetary purposes, the rest being taken to India\* and for the industrial uses. As the requirements for monetary purposes are 3% of the year's stocks, the amount grows in geometrical proportion and the demand, which is estimated at £62 millions for 1931, would be £83 millions in 1940, but the available monetary supply will have decreased from the present £45 millions to £35 millions, leaving a shortage of £48 millions. Even on the basis of 2% increase, the demand will be £50 millions or a shortage of £15 millions.

In view of this expected shortage the Gold Delegation has made certain recommendations for further economy in the use of gold. It is not possible to regulate or control the demand for non-monetary purposes, and the only possibility is to economise in the monetary use of gold. The measures suggested are (among others) :—

1. That countries should try to minimise the use of gold by such methods as the adoption of a lower ratio of gold reserves which would, of course, mean much closer co-operation between the various Central Banks.
2. In those countries where there are still gold coins in circulation, every attempt should be made by the Central Banks to acquire them.
3. Countries should, as far as possible, work on the gold exchange standard, which would mean that, instead of acquiring gold bullion, they would acquire rights to gold in a gold standard centre.
4. The liabilities of Central Banks should be further reduced by extending the use of cheques and *giro* transfers and by improving the clearing systems. For the success of this idea it is suggested that Governments should forego the income from stamp duties on cheques.
5. Notes of small dimensions should be replaced by token coins.

There is one remedy that has not been suggested. So far as Central Banks are concerned, the price they pay for gold is only issue of paper currency. The Central Banks could then decide to work the deeper mines themselves and commandeer the remaining gold production. This would, of course,

\* This demand is dealt with later in this chapter.

mean that gold as a commodity might have to be sold at a higher rate, but even this could be prevented by Central Bank co-operation. It is only when the mines are commercially worked that production is dependent on cost. As soon, therefore, as mines are deserted by the companies, the Central Banks or the B.I.S. could take over their working and thus make gold available in the future in the same quantity as now. Of course, there can be no remedy against the petering out of mines.

It may also be pointed out that the recent depression in prices would have tended to considerably reduce the demand for credit and currency, and this would bring about a fall in the monetary demand in the next few years and also a surplus in the existing stocks of Central Banks. In fact, unless they deliberately work up to higher prices, the gold shortage problem may have solved itself already, to some extent.

The last two suggestions of the Gold Delegation are easily understood and there should be no difficulty in adopting them. The third is in practice fairly commonly, and we have seen that the gold standard countries keep a large part of their resources in gold balances. The second suggestion is easy to adopt though difficult to carry out because those who still have gold coins with them are the diehards in all senses of the word. Nothing would make them part with their gold except their death.

We then come to the most important suggestion, that Central Banks should try to work on a basis of 33% or even 30% of gold reserve. On the basis of 33% and 3% annual increase in circulation, the monetary demand in 1940 would be £70 millions, or a shortage of £35 millions, while even the 2% annual increase would mean a demand of £42 millions, or a shortage of £7 millions. But, through the reduction of the reserve ratio, enough will be released from existing gold stocks to meet the deficit in the gold supply, as a difference in the reserve ratio would mean a surplus of nearly £350 millions which could itself meet the demand for more than five years. After all, the figure of 40% is an arbitrary one and there is no sanctity attaching to it, and some other arbitrary figure

could equally well be fixed for the reserve ratio. The purpose of the gold holding is, therefore, the main factor which should determine whether a lowering of the ratio is feasible.

We have seen that the gold reserve of a Central Bank is mainly for the purpose of international settlements. Even if the country has gold coins in circulation, not all of them would be available at any time for export purposes. The country must have some means of settling internal transactions and cannot spare more than a certain fraction of the currency for export. The amount that will be available cannot be estimated and only an arbitrary figure can be assumed and this arbitrary figure, with a small margin, can be used for the gold bullion standard. The theory of the relation between gold assets and the foreign trade has thus been summarised by Mr. R. G. Hawtrey in a lecture before the London Institute of Bankers (Journal, February 1927):—

“A gold reserve is held with a view to contingencies, particularly to what we may call an adverse clearing balance against the country in world markets, or in the more usual phrase, an adverse balance of payments. It is impossible to calculate beforehand the magnitude of these contingencies and the conclusions arrived at on the subject have everywhere been empirical. They have been picked up from experience with little assistance from theory.

“It is natural to think in terms of percentages. The reserve must be in some sense proportional to the transactions out of which adverse balances may arise. Any bank usually aims at a certain proportion of cash reserves to liabilities to cover both clearing balances and withdrawals of money into circulation. Proportions between 10 and 15% are very commonly adopted by banks which have rediscounting facilities open to them.

“A Central Bank of issue, having no rediscounting facilities available, would naturally keep a higher proportion. Accordingly, gold reserve laws are commonly enacted requiring the gold held to be not less than, say, 30% or 40% or  $\frac{1}{3}$  of the note issue”.

As an illustration, let us see what would be the working of the gold reserve in India. If the Reserve Bank had a liability of 200 crores with 90 crores gold assets, and it become necessary to dispose of 10 crores of gold assets on account of an adverse balance of trade in any year, the actual currency in India would have to be contracted to the extent of 25 crores though, if the contraction were only 10 crores, there would

still be a reserve of 80 crores gold against 190 crores liability, which would be within the legal limit. The foreign trade of India would not, in any case, leave an adverse balance of more than 30 crores in any year. If crops fail in any year and exports dwindle down, the imports must also fall, as the people would not have any surplus to spend on them, having enough difficulty in keeping body and soul together until the next season. The gold reserve need not thus be much more than 60 crores on a liability of 200 crores but the higher percentage of 40% is prescribed so that people may not lose confidence in the currency when a gold movement begins.

The following figures of the foreign trade of some of the most important countries and their gold and foreign currency assets will be found useful as showing the extent to which the gold reserve ratio may be reduced without disturbing the value of the gold assets for settling the international accounts arising out of trade balances :—

*Table 19—Gold holdings and foreign trade of some countries, 1913 and 1929.*

Country.		Exchange Rate	Exports.	Imports.	Gold.	Gold as %
		per £.	(in millions of local currency units)			of import.
France	1913	25.22	6880	8421	3517	42
	1929	124.21	50140	58220	41678	71
Italy	1913	25.22	2512	3646	1376	36
	1929	92.46	15200	21665	5190	24
India	1913	16	2205	182	65	35
	1929	13½	318	182	96	34
Germany	1913	20.43	10097	10770	1170	11
	1929	20.43	12662	13146	2283	18
Holland	1913	12.11	3065	3903	151	4
	1929	12.11	1989	2751	447	16
Switzerland	1913	25.22	1376	1920	170	9
	1929	25.22	2104	2784	595	22
Spain	1913	25.22	1058	1306	480	37
	1929	43.50	2107	2736	2566	94
Britain	1913	...	529	659	35	5
	1929	...	729	1111	146	13

It will thus be seen that the capacity of most currency authorities to meet international balance of payments by means

of gold exports is considerably higher now than it was before the war and that, on this basis, most of them could afford to declare a full gold standard as in prewar days.

The problem for the Central Banks will thus be how to maintain, with the minimum amount of gold, the confidence of the people in the stability of the currency note so as to avoid a monetary crisis. This they do by their control over the available supply of gold for non-momentary uses. Gold has thus ceased to be even a commodity with an intrinsic value and subject to economic laws. If the Central Banks of the world should desire to do so, they can create a scarcity of gold which would be unparalleled in history and, if they only thought so, they could glut the market with gold at a price which would stagger the people who now scoff at the instability of silver as a standard of value. To appreciate the point, one has to remember that, even though we have postulated a shortage of gold in 1940, the demand for industrial uses is never expected to equal the output from the mines. When the whole world together buys £40 millions for industrial uses, how could it cope with a supply of about £80 millions? If the Central Banks, who are the only purchasers, refrain in any year from purchasing the extra £40 millions, the price of gold in terms of commodities must become so low that, burdened with an annual surplus production of one year's demand and an ever growing surplus, prices would break down indefinitely. As Mr. Hawtrey has put it:—\*

“That means that the currency authorities of the world are, on the whole, always buyers of gold. They require reserves to meet possible payments *to one another*, not to meet possible industrial demands.

And the reserves are enormous in comparison with the annual output and industrial demand. The United States holds about £900 millions of monetary gold, England £150 millions, France £146 millions and Germany £80 millions. Many other countries hold considerable sums. The total of monetary gold cannot be less than £2,000 millions and all of this, except a small amount of coin in circulation, is held in reserves.

What a market is this where the dealers hold a stock in trade equal to 25 years supply and probably more than 30 years demand!

\* Journal of the London Institute of Bankers, February 1927, p. 62.



For generations past the currency authorities have been buying up all the superfluous gold off the market and this is the result".

One of the problems which the world has to face to-day is not so much that gold is scarce or that the faith of the people in the currency unit may be shaken, as how to get out of the domination of the United States. From the table given earlier, it will be seen that the gold stocks of the United States was £377 millions just before the war. To-day, it is more near £900 millions and all this amount has been acquired during less than ten years. The war-time payments to the United States for food and other products and the postwar reconstruction created a heavy indebtedness to that country from all the belligerent nations. The volume of such indebtedness for Europe is now £2170 millions. The interest alone on the American investments of £3000 millions in 1920 was £150 millions (and in 1931 it would be £200 millions on £4000 millions) and the only form in which it could be paid to the United States was by exporting gold to it. The yellow metal therefore flowed in an unbroken current towards New York for several years.

"During the war period gold had accumulated in the United States upon a scale unprecedented before that time. The very processes which had made possible the restoration of the gold standard in England and the other countries had contributed during the reconstruction period to aggravate the situation by adding enormously to the already large gold stocks of America. The distribution of gold which finally resulted was a problem which could not be solved upon the principles of the old automatic gold standard"—(W. A. Brown Jr., "England and the New Gold Standard.")

New York thus came to acquire very near half of the world's total monetary gold stock and, whatever other countries would desire to do in matters of price control, they were bound to the chariot wheel of New York and the independence of Central Banks was subject to the restriction that their policies had to fall in line with that of the Federal Reserve System. Thus, if through some action of the Federal Reserve Banks, or through some economic influences such as over-production, the price level in America changes, other Central Banks have to see that their price levels followed the New York movement.

Otherwise, the difference in prices would affect the exchange value of the currency by increases in exports or imports of those countries. Consequently, it has become necessary for Central Banks to follow the lead of New York. This movement will be seen from the following table of index numbers of some of the more important countries, based on the published figures modified in conformity with the prevailing rates of exchange in terms of gold. For the purposes of comparison the index numbers have been adjusted to 1913 base for all countries and also for the exchange value of the currencies in terms of the gold dollar. Thus, if the index number for Japan for 1913 is 132.3, and the index number for 1920 is 343.2 the index number adopted is  $\frac{343.2}{132.3} = 259.4$ . The index numbers are then converted into gold as below. If the index number of prices is 259.4 and the index number of exchange rates is 98.9, the adjusted price index is  $\frac{259.4}{98.9} = 262$ .

Table 20—The Dollar Standard.

Name of country.		Index number (1913 = 100).			
		1920	1925	1928	1931
U. S. A.	...	231	148	140	110
Britain	...	219	148 ('26)*	140	107
France	...	183	135*	126	98
Germany	...	101	141*	140	115
Japan	...	262	166	160*	119
Italy	...	115	133	134*	98
Holland	...	264	173*	167	116
China	...	281	181	155	118
Sweden	...	274	162*	148	114
Spain	...	184	140	141	97

\* Back to the gold standard,

It will be seen that the movement towards the New York price level was more pronounced after the countries returned to the gold standard and that countries like Spain which are not on the gold standard have more or less had to follow New York and this is true even of China which is on a silver standard. In the case of India, a similar adjustment in the index figures would give the following new figures, the adjust-

ment being of the rupee prices to the gold value of the rupee, in accordance with rates of exchange of those years:—

*Table 21—The Dollar Standard in India.*

Year.	Index No. (1913=100)	Index No. In gold.	Index No. in U.S.A.
1922	176	136	138
1925	160	155	148
1928	145	145	140
1931	98	98	110

This dependence on New York must continue until Europe's obligations to New York have been liquidated, and this is as feasible under present conditions as it is to bring the moon within the reach of the arm of the child crying for it. Unless as we point out elsewhere, America changes her outlook and her tariff policy, the accumulation of gold in that country is bound to proceed further but the liquidation of the European debts will come no nearer. The result is that the world will continue to be on the dollar exchange standard in effect for several years to come unless another cataclysmic revolution takes place.

The imports of gold into India have been the basis for some wild criticisms such as that India is an insatiable sink of gold, that, in its desire for gold, it is like a trap from which gold never returns and that the greed of India can never be controlled so as to permit it to have a gold standard. These criticisms have been made because the critics refused to take into account the fact that gold has been a valuable commodity in India from the earliest times and the monetary silver and the later token silver coins of India have not been taken as real money by the people. Secondly, the criticisms became very persistent between 1922 and 1925 but, it was forgotten that India had just exported 55 crores worth of gold in the two previous years, or approximately £40 millions worth. Moreover, during the war years she had been unable to import any gold though she had exported largely in excess of her imports.

The Central Banking Enquiry Committee went into this question in some detail and has quoted several authorities to prove that India's demand for gold is nothing abnormal when

compared with the world's general demand. The population of India is one-fifth of that of the whole world and she is entitled to take off at least one fifth of the world's supply of £83 millions, or about £17 millions. If it is remembered that the monetary gold of the other countries serves the nations more efficiently than mere gold in India, the requirements of the country will be accepted to justify a higher proportion. Now the average net import into India between 1900 and 1930 is only 18 crores or £13 millions, which is less than what she is entitled to.

The claim that the gold import of India can never be controlled sufficiently to permit of the introduction of a gold standard has been disproved by the recommendation of the Hilton Young Commission for a full gold bullion standard. If the facts of the gold imports are considered in their proper perspective, it will be seen that there is a regulated sense of proportion in the Indian demand for gold. The following are the figures of average annual imports and exports between 1884 and 1929 :—

*Table 22—Gold imports into India 1884-1929.*

	Net Gold import.	Of which Gold coin.	Gold export.
	(in	lakhs of	rupees)
1884-99	... 248	...	...
1899-1904	... 955	915	884
1904-09	... 1288	784	575
1909-14	... 2887	164	458
1914-19	... 781	670	623
1919-24	... 1393	991	*969
1924-29	... †3350	792	13

\* 54 Crores were exported in 1919-21.

† 67 Crores were imported in 1924-25.

It will be observed that India has only maintained the prewar average in the postwar years if we take into consideration the whole period from the outbreak of hostilities. The average import for 1899 to 1914 was 17.10 crores and the average for the years 1919 to 1929 was 23.72 crores, which is equivalent to £16 millions at the average rate of exchange. The total non-monetary demand for the rest of the world is over £20 millions and the average total demand of £60 millions

for the commercial nations, which do not number over two-fifths of the world population, would appear as far too high in comparison with us.

The imports into India are not unreturnable. The exports of 1920 and 1931 to which reference has been made show that, if the proper ratio of profit is available, gold from India goes out. And the position of India, even if she had a valve inward for gold, would not be worse than most of the other countries of the world which, as we have seen, have legal and moral embargoes on the free outward movements of gold. Moreover, it is a fact that the net balance of payments have usually been in her favour and she has the right to receive payment in gold or silver at her choice, in the same way as other nations have. Perhaps, if the Government in India had been prepared to issue gold coins in exchange for the imported gold, it might have been found that the Indian mentality towards gold was no worse and no better than that of the other nations.

From the point of view of the possibility of a gold standard for India, there is nothing then, to make it unworkable and, if proper precautions are taken and if the new issue is sufficiently advertised and it shows on its face the backing of the Government of India, as suggested by the Hilton Young Commission, there is no reason why the gold standard in India should not become an accomplished fact very soon.

## CHAPTER XXXIII

### THE GOLD EXCHANGE STANDARD.

*"Holding on to the mother's skirt"*

Gold exchange standard—Foreign balances—Relation to the gold problem—Maintaining the ratio—The reality of foreign assets—Secondary expansion—Creates short term loans—Gold standard ideal.

We have seen that in gold standard countries, the representative note issue is practically the standard of value inside them. In view of the uses to which gold is now being put, it would be seen that a country can equally well be on the gold

standard by tying its monetary unit to that of a gold standard country by a fixed relation. The gold standard presupposes the acquisition of a certain volume of gold in the vaults of the Central Bank ; but, if this is not possible, the same purpose can be achieved by the Central Bank acquiring balances in gold standard countries and using them for settlement of international accounts in the same way as if they were gold stocks. Countries adopting this device are said to be on the gold exchange standard. The essence of the arrangement is that monetary conditions are so well controlled, the local currency is so well managed, and its volume so well regulated, that its external value in terms of the unit of the ideal country to which it is attached remains at a stable level. Most countries are now on the gold exchange standard, more or less, as they use either sterling or dollars and not gold for foreign payments, and it has been found to work quite as well as a gold standard for the purposes of facilitating international trade.

The foreign balance thus serves two purposes. It is a basis for the local note-issue and it is the reserve to fall upon in case of adverse balances of trade. It has, therefore, to be maintained at distinctly higher ratio than the legal one, and it should have a due proportion to the foreign trade of the country. As the basis for the local currency, a high reserve in the form of gold balances is not so serious a danger as a high ratio of gold reserve would be to the problem of the gold shortage. But it is essential that the safety of these foreign assets should be regarded as even more sacred than the earmarked gold or gold balances of partial standard countries, because they are the sole assets of these countries.

For the purpose of maintaining the exchange level the Central Bank of such a country will have three options. The most potent is the variation of currency by open market operations. The second is the raising or lowering of the bank rate. The third is to borrow or lend abroad, so that the local currency may be kept out of the effects of foreign balances. It will be easily understood that, for such a country, a wide departure from the legal rate either upwards or downwards will be equally harmful as the Central Bank will lose control

of the variations in either case. Hence, the rate should be maintained within fairly narrow limits over and below the standard legal rate.

In a gold exchange standard country, all that the currency authority promises is that the monetary unit has a certain exchange value in relation to the unit of the ideal country, and promises to buy any amount of exchange on the ideal country by the issue of paper currency at a rate higher than the standard exchange value by the equivalent of the charges which would have been incurred if gold had been exported to create that foreign balance. It also agrees to sell to the public the currency of the gold standard country in amounts that they may require, at a rate lower than the standard rate by the cost of transportation. Owing to the fact that gold does not actually move either way, the buying and selling limits may be fixed in any arbitrary manner, either narrower or wider than these.

The issue of paper currency in these countries is regulated on the proportional system, the volume of notes and sight obligations being backed by a certain percentage of gold balances. The main disadvantage of the gold exchange standard is the possibility that the volume of note issue may be increased by manipulation. Thus, the currency authority might pay out notes to acquire corresponding gold assets, and make these assets the basis for issue of new currency.

There is also the possibility of gold being used by two or more countries as the basis for currency expansion and of its being unavailable to any of them when a crisis develops. The position would be exactly like that in the American banking crisis of 1907. There, the country banks increased their liabilities unduly, but satisfied the legal requirements by holding a balance with a town bank, which was regarded as cash. The town bank, in its turn, maintained a cash reserve with a city bank on which it depended for emergency help. The city bank held the proper resources in its till. Now this meant that the 15% cash reserve of the country bank was part of the town bank's liabilities and was covered only by the 15% cash which it had with the city bank, and this bank itself had only 15% of its own liabilities in cash. The result was that the real cash

reserve of the country bank in the assets of the city bank was 15% of 15% of 15% or 0.34% of its liabilities. A similar development is possible with the gold resources of exchange standard countries. If country A has gold balances in country B and issues notes against their security, these assets are a liability of the Central Bank of country B and are secured only by 40% gold; the notes of country A are, therefore, secured only by 40% of 40% or 16% gold reserve. And if country B has an exchange standard relation with country C, the case becomes worse, the actual reserve being 40% of 40% of 40% or 6.4%.

There is one danger in the gold exchange or silver exchange standard to which attention should be called. It arises from the fact that such a country keeps all its resources in the ideal country. When that country suspends specie payments, the other one has to follow. Thus, when France goes off the standard, so would Indo-China and Morocco, Congo and Madagascar. If Holland is off it, so would Java be. When England departed from it in September 1931, her colonies had to decide whether they would disclaim the mother or go along by her side. Such a possibility made the Canadian dollar to be quoted for a few days at a discount in New York. South Africa cut herself away from England and remained loyal to gold while Australia and New Zealand had no interest in the question as they were already off it. India and the Strait-Settlements had to stick to sterling because they could do nothing else and the uncertainty of sterling values attached itself to the rupee in relation to other currencies. Thus, the dollar was quoted at about 360 for selling and about 320 for buying, or a margin of about 12%.

There might also be secondary expansion in country A, as in the case of partial gold standard countries, with the difference that an exchange standard country has no gold at all to fall back upon. The danger to country B, out of these gold balances of country A, remain the same and it is quite possible that the unsoundness of the policy of one Central Bank might adversely affect the other. The conversion by country A of its gold balances into gold would cripple country B and a crisis in that country might precipitate one in country



A on account of its assets being wholly abroad. It is, therefore, necessary that the men in charge of Central Bank policy should be men of judgment, character and probity, one had almost said, of piety. They should have no axe of their own to grind and should be free from any sort of influence, political, clannish, or of social or economic groups. Otherwise, the temptation to manage the currency in their own interests, or of their parties, would be too strong for them.

The remedy to this state of things does not lie in the direction of trying to make gold exchange assets work in the same manner as gold assets, that is, by transferring them at once from the centre where they are acquired ; for,

"If Berlin should purchase foreign exchange in London it would be obliged to transmit it to New York and *vice versa*. The analogy is only apparent. Should all banks using the gold exchange standard actually apply the principle of an immediate transfer of foreign exchange, a feverish arbitrage in the currencies of the countries which are gold centres would ensue. Irrespective of the rate of exchange of a given currency, and independently of the rate of interest, the foreign exchange of one gold centre would be changed into the foreign exchange of another. The accumulation of such arbitrage operations would necessitate gold export at times in order to protect the rate of exchange of that currency which might be endangered by a sudden accumulation of its supply for purposes of arbitrage" (F. Mlynarski, Gold and Central Banks).

The resulting state of things might be more unreal still. If country A, country B and country C maintained foreign balances with London and New York and C acquired a London balance it will have to sell it for New York funds. The London funds would probably be bought by some other Central Bank and the purchase would be made with New York funds so that, except that they have exchanged the venue of their foreign holdings, the balances of foreign banks in London and in New York remain unaltered. If the sale is to private parties, it might result in the heavy demand for New York funds in London or *vice versa*, which would require an export of gold to counteract.

The gold exchange standard results in practice in the ideal country borrowing from the others for short terms. To quote Mr. Mlynarski again :—

"The steadily increasing accumulation of foreign exchange reserves is the most essential feature of the gold exchange standard. The accumulation of foreign exchange reserves, however, is nothing other than an accumulation of short term credits granted to foreign countries by the banks which apply this system."

We have seen that, even under the gold standard, the accumulation of gold in the vaults of the Federal Reserve Banks in the United States has made it obligatory on other nations to maintain parity with dollar prices and the policy of the other Central Banks loses the vitality and the initiative that would belong to them under a freely functioning gold standard. The case is even worse with the gold exchange standard. A country linked with sterling might have to follow not only the policy of the Bank of England but also that of the Federal Reserve Banks and, between these two factors, the possibility of initiative for that Central Bank would seem to be nearly absent. Still, it might have to be tolerated as it might be the only means of linking the local currency with the rest of the world which is on the gold standard.

The gold exchange standard can then work properly in two cases. One is that of a colony and a mother country as, for instance, Britain and the Dominions, the Netherlands and Java, France and Indo-China, Italy and Tripoli. It could also work well in cases of countries like England and India which have intimate financial and other relations for which a London balance is more valuable than gold itself. The working of the Indian currency system has, therefore, often been held out as an example of how a gold exchange standard should be operated in practice.

The gold exchange standard should, however, be looked upon as a starting point for the attainment of a full gold standard which alone will give the country the true stability which is the object of coming in line with the rest of the world. When the decision to convert into a gold standard is taken, there will be the problem of the conversion of gold balances or silver or other assets into gold, and this clearly cannot be done at once. For, apart from the impossibility of the monetary

supply of gold being sufficient for the purpose, there is the demand of other gold countries competing in the market. But if the demand is spread over a period, and gold acquired gradually as it appears on the free markets of the world, the process can be so managed as not to disturb the international value of gold itself.

## CHAPTER XXXIV.

### MONEY RATES AND THE EXCHANGES.

*"The strings that make the puppets dance"*

How money rates work—High money and low exchange rates

—Low money and high exchange rates—Effect only relative—

Indian bank rate—Steady bank rate—Call money rates.

In most countries where there is a properly regulated money market, the bank rate has a double significance. It represents, as far as internal credit is concerned, the cost of accommodation ; its raising and lowering, therefore, is followed by a corresponding change in the interest charge of commercial banks and, if there is a discount market, by a change in the rate at which bills will be discounted. When the banks are refractory or the discount market refuses to follow the lead, the Central Bank would bring them into line by its open market operations. But the bank rate has an equally important, if not more important, function to perform in maintaining the external value of the currency. This it does by varying the supply of short term credits in the market. Whether the country be a full fledged gold standard one or a partial gold standard one, or a gold exchange standard or even a silver standard one, the bank rate is a very potent weapon in this respect.

When the exchange rate moves against the country the bank raises its rate, and the movement of all the other rates with it attracts money from other countries and recalls local money invested abroad, trying to take advantage of the higher rate. This means that the local currency is in greater demand and there is a tendency to rectify the previous movement in

the exchange rate. Similarly, if the exchange rate moves in its favour, the lowering of the bank rate and the other rates with it, would drive away local and foreign money for investment abroad, the demand for foreign currency thus reversing the former exchange movement. These parties would usually protect themselves by making forward contracts for the return of the funds. Hence, the strength in the ready rate is compensated for by a weakness of the forward rate and an easing of the ready rate brings about an added strength in the forward rate. Herein lies the defect of the use of the bank rate for exchange purposes, that it is a purely temporary but emergency measure, that might be compared to a doctor giving a strychnine injection which would not cure the malady but would give the body time to organise to fight the disease. The exchange movement would not be offset but the day of reckoning would be postponed. Hence, unless the Central Bank is confident that, in a short time, there would be conditions in the exchange market which would counteract the artificial forces on the forward market, it would be wise in using the rate only as an extreme measure of temporary value to give it breathing time.

The effects of raising the bank rate and the limitations to which it is subject as an influence in the foreign exchange market were thus described by the Cunliffe Committee of England in its Interim Report of 1918:—

"If the adverse condition of the exchanges was due not merely to seasonal fluctuations, but to circumstances tending to create a permanently adverse trade balance, it is obvious that the procedure above described would not have been sufficient. It would have resulted in the creation of a volume of short-dated indebtedness to foreign countries which would have been in the end disastrous to our credit and the position of London as the financial centre of the world. But the raising of the Bank's discount rate and the steps taken to make it effective in the market necessarily led to a general rise of interest rates and restriction of credit. New enterprises were, therefore, postponed and the demand for constructional materials and other capital goods were lessened . . . . The result was a decline in general prices in the home market which, by checking imports and stimulating exports, corrected the adverse trade balance which was the primary cause of the difficulty."

The maintenance of the exchange rate through manipulations of the discount rate means, of course, international co-

operation because, if other Central Banks also raised their rates of discount, the effect of one Bank's action would be nullified by that of the others. The result might be an all-round dearness of money without any effect on the trend of exchange movements. Internal trade might thus be penalised without advantage to anyone except the lenders of money and credit, who would make higher profits. What is required is not an *absolutely* higher bank rate which would be useful for restricting internal credit, but a *relatively* high rate.

It is like one nation building up armaments hoping to establish a naval superiority over others ; but, so long as others also build new ships, the real effect is not superiority, but a higher cost to all nations concerned. On the other hand, even a reduction of armaments might establish superiority or maintain existing superiority if, by agreements such as the "Four Power Pact," all countries reduce the size of their armaments to the same extent. Similarly, even a low bank rate like  $2\frac{1}{2}\%$  might be relatively higher than  $2\%$  elsewhere while even  $6\frac{1}{2}\%$  might be relatively lower. This was illustrated during the great Wall Street boom in New York in 1928-29. When the New York Federal Reserve Bank raised its rate of discount in order to check speculation, other Central Banks had to do the same thing in order to prevent money flowing from their centres to New York. Neither of these actions were successful, because the profits of that speculation were so high that some persons gladly paid interest at  $15\%$  to  $20\%$  for the use of money. The flow of foreign funds into New York increased at terrific speed and, but for the somewhat early collapse of the boom, the Central Banks might have had to confess the inefficacy of all their weapons when the world runs "amok." It is also illustrated in the recent happenings in London. In spite of the rise in the Bank of England rate from  $2\frac{1}{2}\%$  to  $4\frac{1}{2}\%$  in two successive weeks, foreign balances continued to be steadily withdrawn (totalling more than £200 millions) and it became necessary to suspend the gold standard and raise the bank rate to  $6\%$ . Even then there was little effect on the exchanges or on the movement of funds.

There is thus a limit to the extent to which the bank

rate can be used to maintain the exchange level. If the Central Bank should raise the level unduly high or even vary it too often, foreign money is put on guard in the same way as a lender begins to doubt the value of a proposition when the borrower is prepared to pay an economically unworkable rate of interest. Instead of attracting foreign money, it might scare away even existing investments and the credit of the country abroad might be shaken violently. The purpose of the bank rate differences is to establish a margin, perhaps more on the ideal of the homeopathist, slight it may be, but enough to attract investors. It is not to act in the nature of a virulent poison which might kill or cure.

Moreover, the Central Bank has its duty towards internal credit requirements, and a steady bank rate and market rate are essential to ordered progress of trade, industry and commerce on which foreign exchange depends for its life. In England, during the eighties of the last century, the bank rate used to vary between  $2\frac{1}{2}$  to  $5\frac{1}{2}$ %, or a range of 100%, with an average of 4%. But the stabilisation of the rate was thought so important that the variations have now been considerably reduced. Between 1921 and 1930 the average rate was 4.4%, but the range has been limited to nearly 30% in the ordinary years, while in some years, the rate has been the same all through. England, of course, has the advantage that it is the financial centre of the world, and other countries have had generally to follow its lead and regulate their rates in accordance with the London rate. The steadiness of the London discount rate is of special importance to the foreign banks in India, for their contracts to buy bills are made several months in advance and, if there was the chance of the actual rates being very different from those on which the banks made their calculations, the spread between sight and time bills would have to be much wider than now. At present, the banks know that, in the usual course of things, the rate would be the same and though there may be variations in the rate, they are likely to be quite narrow.

In India, the bank rate has no such meaning, though the official rate of the Imperial Bank of India is quoted in financial

journals with that of the Central Banks of the world. In the first place, the Imperial Bank of India is a Central Bank only in the sense that other banks keep their balances with it, and currency moves into and from the country through it. But, being a competing commercial bank, it cannot expect its rate to have any meaning except that it would lend to its constituents at that rate. Other banks do not resort to it in times of necessity as to a Central Bank and they rather borrow from it by cash credit, not liking the method of rediscounting bills on account of the possibility of letting it know the kind of bills they handle.\* Secondly, it does not indicate the lowest rate at which credit would be given, but is an indicator of the tightness or easiness of the money market. The really effective factor in exchange is the three months inter-bank rate and the call money rate and these rates have nothing to do with movements of the Imperial Bank of India rate, except when the latter coincides with a very tight money market. Consequently, in normal times, a high bank rate does not have any influence on the exchange rate. If the Imperial Bank of India had some means of regulating the supply of bank cash, it could make its rate really related to the money market rates and thus exercise some influence on the exchange rate. As it is, it is as eager as other banks to invest in securities in the slack season just when, as a Central Bank, it should be selling securities to take off the surplus money from the market. Similarly, it is selling securities in the busy season when, as a Central Bank, it should be buying them, and it tries to meet the demand for money by increasing the cost of accommodation, instead of satisfying it by issue of new currency.

The call money market in organized centres like London and New York consists of funds seeking investment from day to day. These funds are lent with the understanding that the loan is for 24 hours, but if not recalled within an hour or so after opening of business the next day, it is to continue for another day, and it is the cost of these funds that determines

\* Evidence of the Managing Governor of the Imperial Bank of India, before the Central Banking Enquiry Committee.

the market rate, which decides whether foreign money will come into or go from the country. Money at call in London is nearly constant in volume and is usually 2% below the bank rate and a fall or rise in the latter would be accompanied by a similar movement in the former.

In India, on the other hand, the call money rate is not so related. Though, when the bank rate is high, the call money rate is high, and when the bank rate is very low, the call money rate is very low, the difference between the two rates is neither fixed nor proportional to the rate. The reason is that between November and March when money is in great demand, new money does not come into the market and in the slack season between May and September, the banks have large unlendable surpluses for which they cannot find investment of the same type as short term maturities elsewhere. The Government of India does sell Treasury Bills, but these are continued almost all through the year and are more concerned with its Ways and Means position than with currency purposes. Hence, we find that call rate is sometimes very near bank rate at 7 and  $7\frac{1}{2}\%$ , and sometimes very low at 2% and even  $\frac{1}{2}\%$ , when it is said to be unlendable. It is this rate which decides whether, during the busy season funds will be brought from abroad and, in the slack season, whether Indian funds will be taken out of the country.

When the Reserve Bank is established, it will try to create in India conditions similar to those in other countries. Through its open market operations it will regulate the supply of currency in accordance with the trade demand and the volume of loose funds in the market will tend to be fairly constant, so that the call money rate will become related to the bank rate and its special influence on exchange will disappear. The bank rate will then be the dominant factor in exchange; if it is raised, it would tend to attract foreign money; and when it is lowered, there would be an outflow of funds.



## CHAPTER XXXV.

## LUNAR AND OTHER STANDARDS.

*"As changing as the inconstant moon"*

Variations in silver countries—Effect on foreign money—  
Bimetallism—Paper standard—Postwar paper standard—Note  
issue and exchanges—The return to gold.

A country may be on the **silver standard** to-day but, so far as international relations are concerned, it may be as bad as if it were on a paper standard. The paper standard creates an almost limitless fluctuation in the price of the local currency in terms of gold and therefore difficulties arise in meeting international obligations. The same thing happens to silver. Most countries being on the gold standard, silver is often more of a commodity in those countries than gold, and its gold price varies with the supply and demand of silver. During the war and after there was a great demand for silver for token currency, chiefly in India where notes, though common, had not become popular and the unpopularity was increased by the lack of restrictions on their issue. This intensive demand for silver increased the price from 24*d.* in 1914 to 80*d.* in 1918 and 89½*d.* in 1920, the highest New York quotation being \$1.63 per ounce. The postwar reconstruction programme of the several Governments brought about a reconstruction of the financial machinery as an essential part of it, and the confidence in the Governments and the Central Banks of issue made it possible to substitute notes for the token silver. The unloading of this silver became a depressing factor in the silver market. Steadily, day by day almost, the price of silver began to fall down until it touched 35*d.* in 1922. In 1926 came the Government of India's decision to dispose of its silver assets totalling about 400 million ounces and this operated as a powerful bearish factor in the market, driving down the price from 30*d.* towards the end of 1926 to 12¼*d.* in 1931. It will thus be seen that, for purposes of international trade, silver is an unsatisfactory medium of exchange. All countries are now

going to the gold standard and the time may come when all that is left of the silver standard will be a skeleton like that of the "Ichthyosaurus."

If a country, then, were on the silver standard, the value of its currency unit must vary to the same extent as silver. Taking the case of China as the best example, the Shanghai tael, on the basis of which foreign settlements are made by China, is about 1.18 ounces of silver. Its value would be \$1.91 when silver was \$1.63 in 1920, and only 31½ cents when silver was 12¼d. or 26 cents per ounce in May, 1931. This gives a range of 620% and the disorganisation of China's foreign trade through such variations can well be imagined. Suppose that, at a certain price, \$1.91 of the tael, a quantity  $Q_1$  of exports is able to buy  $Q_2$  of imports, and the tael falls to 95 cents,  $Q_1$  of exports would be worth only half what it was before and would purchase only  $\frac{1}{2}Q_2$  of foreign goods. China would then have either to curtail her consumption of foreign goods by half, or export twice the previous quantity of home products, that is,  $2Q_1$  of goods would buy  $Q_2$  of foreign goods.

If we go down to the stage when the tael was worth barely 32 cents or one-sixth the old tael, China would have to export  $6Q_1$  of goods or be content with  $\frac{1}{6}Q_2$  of foreign goods. The effort, the capital, the organisation, to meet such varying conditions cannot exist in even the most highly organised countries, and to create, within ten years, an exportable surplus of six times the previous volume is beyond the limits of human possibility.

The problem becomes more complicated on account of China having to pay her indemnities. These are a form of invisible imports against which China must export real goods to acquire the necessary foreign currency. Hence, out of the exports an increasing proportion will be used for paying the indemnity and a decreasing amount will be available for buying imports. For example, if  $Q_1$  of exports paid the indemnity with  $I$ , and the rest bought  $Q_2$  of foreign goods, and silver falls to one-sixth of its value, an increase in exports to  $3Q_1$  will not buy  $2Q_2$  of imports and not even  $Q_2$ , because  $6I$  will be taken up for the indemnity, and the balance can buy only

something less than  $Q_2$  of foreign goods. The reverse is true if the price of silver rises, as China could export the same quantity of goods and buy more foreign goods with them after paying the indemnity.

Just as between two gold standard countries, there is a mint par but the actual rate would be at variance with it, so there is, between silver standard and other countries, an *ephemeral, legal parity* which is the value of the local currency in terms of gold on the basis of the price of silver ; and the exchange rate moves round this parity. Thus, if silver is quoted at 16*d.* in London, the legal parity of the tael is,  $16 \times \frac{40}{37} \times 1.18$  or  $20\frac{1}{2}$  *d.* The exchange value of the tael will vary above or below it, depending upon whether China is importing or exporting more. In the former case, silver should try to come near export parity from China as that might be the only way to balance the foreign payments. In the latter case, the surplus exports would have to be settled by imports of silver and the rate should tend to import parity. The range between the two quotations for the same price of silver is nearly 4% and, in the case cited above, the actual rate may vary between 20*d.* and  $20\frac{1}{2}$  *d.* The factors affecting the exchange rate between China and other countries are, therefore, the price of silver and the supply and demand for exchange in China.

The influence of silver price on Chinese trade is instructive. If the price falls, the importer finds that he has to pay more taels for his goods and, consequently, tries to push up the London quotation by buying silver there, forward or ready, though he intends only to re-sell it there. Similarly, the exporter would try to push down the rate so that he could get more taels for his goods. It is only when the transactions are over that the price of silver will be allowed to move normally. This is the reason why, on several days, advices about silver state "Chinese speculators buying" or "China selling" which should be taken as a warning to ordinary operators to "keep off the grass" because, when China starts to operate in the silver market it is not the case of a bull in a China shop but of a China in a bull shop.

One of the problems connected with trade of any sort in China for foreign companies is the depreciation of capital. Thus, if a company starts with a capital of £35,000 at a time when the tael was worth 42*d.* in London, it would have been converted into Shanghai taels 200,000. If it had been making a profit of 10% and putting a reserve of 10,000 taels every year, it would have a capital value of 300,000 taels after ten years, but, if at this time, the tael was worth only 16 pence, this would equal only £20,000 and the shares, which should be quoted at about £50, would be worth only £20 each. The reverse would be the case if the price of silver had risen, and foreign companies would make an unearned increment in capital value. These conditions would be reversed in the case of Chinese companies operating abroad. To protect themselves against such loss, foreign companies would try to work with money borrowed locally, or with capital brought in for short terms, with forward contracts for the return of funds. The latter method cannot, however, be popular with many concerns and the former is not usually possible.

The condition of Mexico is almost the same as China. Though it is on a nominal gold standard with gold coins, the actual currency is silver in the form of the Mexican dollar whose value fluctuates with the price of silver. It has been several times stabilised at various exchange values with the United States dollar, but as there was no authority to control its issue, it has always broken away. The latest attempt was at 49.85 cents but in May 1931, it was quoted at 47.50 cents.

An attempt was made by the Latin Union to use both gold and silver as standards of value and the countries adhering to it agreed to issue gold coins and silver coins at a fixed ratio of 15½ oz. silver to one oz. gold. In 1865 France, Italy, Belgium and Switzerland agreed to adopt a uniform monetary system on the basis of a gold coin unit weighing .32258 gramme 900 fine which is the equivalent of 9.513 pence with subsidiary silver coins with full legal tender value at the agreed ratio. This was the principle of the **bimetallic standard**. The countries agreed to maintain currency in proportion to population and to accept coins of other members of the Union at their face value. It

gathered new adherents in the course of its progress but, though it worked smoothly for some years, the silver coins had a tendency to become token coins when the gold price of silver fell, and to be at a premium when the silver price rose. In the former case, the public and the banks were fighting with each other, one trying to get gold coins and the other, to issue silver coins instead, as permitted by law, resulting in a premium on gold coins. In the latter case, the fight was between the public trying to get silver coins to be exported abroad and the banks trying to issue gold coins.

Bimetallism as such died during the war, not only because most of its adherents had to forswear the gold part of the standard, but also because the tremendous fluctuations in the gold price of silver made the maintenance of the fixed relation a chimerical project. In December 1925, Belgium renounced the Union, France in August 1926, Italy in September and Switzerland like a hero in the stricken field of battle, carried the standard aloft till December, when it too capitulated and acknowledged undivided allegiance to gold. Though the Union is now dissolved, several countries have preserved the traditional ratio of the franc with the pound at 25.22 but silver is rapidly declining from the position of a precious metal to that of the baser metals and, in recent years, it is believed that part of the fall in its gold value is in sympathy with copper, tin and other metals, which have only commodity value.

**Paper Standard** countries are on the same level as silver standard ones, so far as the outside world is concerned, with the difference that there is a limit to the variations of the latter, dependent on the price of silver but, in the former, there is no limit to the movement, which is usually one of depreciation and very rarely of appreciation. The remarks made about the difficulties of silver standard countries apply, therefore, with greater force to paper standard ones.

In some countries like Brazil and Argentina there are only paper notes used as currency, without being backed by a proper proportion of gold or silver ; and its external value must depend upon the total volume of notes in circulation and the state of the foreign trade. An increase in the volume of the circulating

medium has a general tendency to weaken the international value of the monetary unit and, similarly, a decrease in the volume will strengthen it. This is true enough of even gold or silver currency and much more of paper notes, but the difficulty is, there are no restrictions on the expansiveness of paper currency. If the exports are in excess of imports as a general rule, then each year there should be acquisition of gold assets which, though not sufficient to make it a legal reserve, could be of value in creating confidence in the currency owing to the fact that, in times of adverse balance of trade, this gold would be available for settlement of international indebtedness. If, on the other hand, during a period of years imports exceed exports it will become necessary for the country to export gold assets or sell its balances in foreign countries and, in either case, the credit of the country is bound to suffer, and the value of the currency must depreciate either through the absence of foreign assets to sell or the psychological effects of their decrease.

There is no limit to such depreciation of the currency because there is no means by which the factors tending towards depreciation can be controlled. Imports could be curtailed but this in itself shows a capacity to reorganise the financial and commercial activities, which would be impossible when we have supposed that imports usually exceed exports. The contraction of currency internally might be possible ; but the improvidence of the people in importing too much must also affect the Government, whose unbalanced budgets would have to be compensated by the issue of new currency. Even if Central Banks were in existence to control currency operations they could only spread out their hands in helplessness over the situation.

Even in the case of an appreciation of the internal value of the currency there would be no limit. The country has been called a paper standard country for the reason that the gold assets, if any, do not amount to much. Consequently, even the increase in gold holdings for some years cannot result in the accretion of such reserves as would justify the stabilization of the currency at any specific value.

Just after the war, we have seen that most countries were

out of the gold standard, and practically on a paper standard with the result that there was no knowing what the relation of the monetary unit was to gold. The United States dollar was the only currency linked with gold and if it became necessary to indicate the true value of any currency, it was usual to quote its value in terms of the dollar. The pound had depreciated in June 1921 to \$3.82 and, on July 29th, touched the low level of \$3.55. It was steadily rising up from that date to 1925 when it was stabilised at the old level. And when the French franc was quoted at 76 francs per pound, its depreciation was not only to the extent that it had fallen from the prewar value of 25.22 francs per pound but also the extent to which the pound itself had fallen. In other words, its gold value fell from 5.18 cents to 1.26 or less than  $\frac{1}{4}$  of its previous value. Similarly, most European currencies had flown away from the gold standard.

The influence on the exchange value of paper currencies of inflation and deflation should, therefore, be well illustrated by the postwar conditions of these countries and the table in pages 278-279 gives an idea of these variations. The first number in each case gives the note issue in millions of local currency units ; the second gives the exchange ratio as the relation between the value of the United States dollar in terms of local currency at that time and its par value, the third gives the price index number on the basis of 1913. The figures in brackets indicate the number of zeros in the amounts. The price index numbers have been given without any correction for the exchange rate at the time ; in other words, they show the low level to which the local currency unit had been driven through the process of inflation. The exchange ratios are also given as index numbers, taking as base, the number of local currency units per gold dollar in 1913. Thus, if the French franc was worth 14.25 per dollar in 1920 against 5.18 in 1913, the exchange index ratio would be  $100 \times 14.25/5.18$  or 275.

This table is referred to later on in connection with the variations in purchasing power parity as exemplifying the relation between price index number and note issue and also between it and the exchange ratio.

It took more than seven years of strenuous and continuous effort on the part of the Governments and the people to bring some of these currencies back to the gold standard. Some of them have not even now been able to come back and, like the boxer who is once beaten, they are out of the ring. Not all of them, however, could go back to prewar parities. New currency units or new exchange ratios had to be created for the purpose. Of the Latin Union, Switzerland was the only one to go back to 25.22 per pound. France had to be content with stabilising the franc at about one-fifth of the old value at 124.21 per pound. In Belgium the franc was valorised at 175 per pound and the "belga" of five francs was created so that the unit may have some dignity. Italy had to be content with keeping the lira at 92.46 and the other important member, Spain, is still far from the gold standard, or at least from the old parity. Several minor countries returned to a gold or gold exchange standard on new bases, and some others are still enjoying the uncertain fortunes of paper currencies. Of the Scandinavian Union, Denmark, Norway and Sweden successfully returned at the old parity of 18.159.

The flux of gold into a paper standard country may not create confidence in the outside world, but it might cause a good deal of dislocation in the internal currency. Thus, in Brazil, a gold milreis of 27d. value was thrown off the gold standard by currency depreciation and in 1913 it was quoted at 16d. But the later introduction of gold notes, according to Gresham's Law, made them disappear as fast as they were issued. For a time, exchange on Rio de Janeiro was quoted in terms of the gold milreis and the paper milreis, but after the war the first was dropped. In 1926, the milreis had depreciated to  $8\frac{1}{8}$ d. and in 1927 to  $5\frac{1}{8}$ d., at which rate it was stabilised with a gold backing of 1250 million milreis. But this rate itself was not steady and, in 1930, it was quoted at an average rate of  $5\frac{1}{4}$ d. and, in December 1930, the gold assets had gone down to 130 million milreis, and in March, 1931, the rate on Rio de Janeiro was quoted at  $3\frac{5}{8}$ d.

Spain is an example of the proverb "He who hesitates is lost." Its gold resources in 1927 stood at 2600 million pesetas



Table 2.—*Note Issue, Index of Exchange Rates and Index of Prices of some Countries, 1920-1926.*

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Name of country	1920	1921	1922	1923	1924	1925	1926	
Germany	81,154 2,481 1,486	122,163 44,219 1,911	129 (4) 17 (12) 34,182	497 (6) 103 (12) 166 (11)	1,941 100* 137	2,960 100 142	3,736 100 134	
France	37,552 275 503	36,417 258 353	35,953 233 326	37,763 317 414	40,604 368 486	49,993 404 546	52,449 595 697	MARK
Belgium	6,260 262	6,415 259 366	6,876 251 367	7,537 369 497	7,873 415 573	7,814 405 559	9,646 572 744	BEK
Italy ...	22,000 390	21,476 449 517	20,279 406 529	19,675 419 536	20,514 443 554	21,450 485 646	20,133 496 654	NGH
England	481 133 307	433 126 197	398 110 159	405 106 159	397 110 166	385* 101 159	381 100 148	
Denmark	557 170 341	471 151 178	459 127 181	473 146 210	478 160 234	438 127 157	386 102* 141	

\* The country returned to gold that year.

Table 23—*Note Issue, Index of Exchange Rates and Index of Prices of some Countries, 1920-1926.—(Contd.).*

Name of country	1920	1921	1922	1923	1924	1925	1926	LUNAR AND THER STANDARDS
Sweden	760 131 359	628 119 222	584 102 173	576 101 163	537 101 162	530 100 161	525 100 149	
Holland	1,123 117 292	1,046 120 182	1,044 104 160		957 105 156	892 100* 155	830 100 145	
Finland	1,341 496 931	1,356 893 1,214	1,421 892 1,142	1,352 719 1,111	1,250 769 1,154	1,309 765 1,218	1,346 100* 154	
Spain ...	4,326 121 221	4,244 143 190	4,137 125 176	4,388 134 172	4,547 145 183	4,440 135 188	4,339 130 181	
Brazil ...		2,049 144 ...	2,233 250 ...	2,649 317	2,974 296	2,707 266	2,589 225	
India	1,614 (at 18d. gold) (at 18d. gold)	1,725 136 167	1,742 127 156	1,834 117 153	1,792 115 154	1,918 100 142	1,812 100 133	

\* The country returned to gold that year

and the peseta could have been stabilised at its value of 28.50 per pound. But the authorities wanted to return to the ideal 25.22 and a stabilisation allocation of £6 millions was wasted in a vain effort to achieve that ideal. Since then, its gold resources have not been available for exchange purposes and the peseta has been dropping steadily through 41.75 in 1930 to 45.25 in 1931 March and about 60 in July 1931. Even now, if only the country would have the courage to start at this ratio, or something a little higher and announce its intention to keep to it, it is possible that it can come back to the ranks.

Perhaps a similar thing is happening in India. Several economists have contended that the 18 pence ratio is too high and that it has resulted in a wasting of the gold assets of the Government. In the Gold Standard Reserve and in the Paper Currency Reserve together, there were 110 crores in 1926 and in June 1931, the total stood at less than 70 crores. But, perhaps, a good proportion of the loss was due to the uncertainty of the capacity of the Government to maintain the ratio at 18 pence. A Reserve Bank started in 1927, as it seemed possible at one time, might have saved the gold resources from this depreciation.

## CHAPTER XXXVI

### CURRENCIES OF OTHER COUNTRIES.

*"Survey mankind from China to Peru"*

Various currencies—Value in rupees—Currencies described.

The following description of the currency systems of the more important countries of the world will be found useful for reference. It used to be believed that the best test of a person's intimate knowledge of the subject of Foreign Exchange consisted in his being able to tell off-hand the name of the currency unit of Ruretanian and its subsidiary coins. Now, where Ruretanian is, none knows except perhaps Stephen Leacock and, happily, nowadays one is not disqualified by his ignorance of such matters so long as he is able to hunt them out at leisure. Much of the information below is taken from Mr. S. E. Thomas' "Principles

and Arithmetic of Foreign Exchange" brought up to date and supplemented through personal knowledge of these matters.

The list on pages 282-283 shows the important currencies with their equivalents in rupees and the equivalent of the rupee in terms of them. The symbols (a) gold standard (b) gold exchange standard (c) silver standard (d) paper standard, have been used.

### **I. Britain and associated countries.**

- **GREAT BRITAIN** (and Irish Free State). The currency medium is the Bank of England note which is unlimited legal tender and represents the sovereign for all practical purposes. Through the adoption of the gold bullion standard, gold coins are not in circulation; though the "ideal" coin is to contain 123.274 grains  $\frac{1}{12}$ ths fine, it is legal tender down to 122½ grains. There are half-sovereigns but they are very rare now. There are smaller token coins for the shilling, crown, half-crown, sixpence and so on.

(a) **AUSTRALIA**. The unit is the pound which circulates in the form of British sovereigns side by side with locally minted coins of the same weight and fineness. There is a good volume of note issue which has recently depreciated heavily being quoted at as low as 130 to 100 British sovereigns.

(b) **NEW ZEALAND**. The currency consists of English coins and notes of the Bank of England, Bank of New Zealand, and some Australian Bank notes. The Bank of New Zealand notes are at a discount of 8%.

(c) **SOUTH AFRICA**. The monetary system is the same as that of Great Britain, the sovereign being the standard of value. As half the exports of the country are in the form of gold, there is usually a discount of  $\frac{1}{2}\%$  on the South African Pound, representing the cost of transporting the gold to London. The present note issue of the Reserve Bank is fast superseding the issues of the other banks.

(d) **JAMAICA, WEST AFRICA**. The currency is the British sovereign and some small coins issued by local authorities.

(e) **KENYA, TANGANYIKA, UGANDA**. The currency is

Table 24—Currencies of some countries, with their equivalents.

Name of country.	Currency.	Value per rupee	Value in rupees.	Class	Minor coins.
ASIA—					
India ... ..	Rupee ...			b	16 annas, 192 pies
China ... ..	Hongkong dollar			c	100 cents
	Shanghai tael			c	1000 cash
Japan ... ..	Yen ...	0·735	1·36 $\frac{1}{2}$	a	100 sen
Java ... ..	Florin ...	0·908	1·20 $\frac{1}{2}$	b	100 cents
Philippines ...	Filipino ...	0·730	1·37	b	100 centavos
Ceylon ... ..	Rupee ...	1·00	1·00	b	100 cents
Persia ... ..	Kran ...	...	...	d	
Siam ... ..	Tical ...	0·825	1·21 $\frac{1}{2}$	b	100 satangs
Straits Settlements	Straits dollar	0·643	1·55 $\frac{1}{2}$	b	100 cents
Palestine ...	Gold Pound ...	0·075	13·33 $\frac{1}{3}$	b	1000 mils
AFRICA—					
Kenya ... ..	Shilling ...	1·5	0·66 $\frac{2}{3}$	b	100 cents
Egypt ... ..	Egyptian £ ...	0·073	13·69 $\frac{1}{2}$	a	100 piastres
Soudan ... ..	Gold Pound ...	0·073	13·69 $\frac{1}{2}$	b	100 piastres
South Africa ...	Sovereign ...	0·075	13·33 $\frac{1}{3}$	a	20 shillings
West Africa ...	Sovereign ...	0·075	13·33 $\frac{1}{3}$	b	20 shillings
AMERICA—					
United States ...	Dollar ...	0·365	2·73 $\frac{11}{16}$	a	100 cents
Canada ... ..	Dollar ...	0·365	2·73 $\frac{11}{16}$	a	100 cents
Argentina ... ..	Peso ...	0·379	2·63 $\frac{5}{16}$	d	100 centavos
Brazil ... ..	Milreis ...	0·667	1·49 $\frac{3}{8}$	d	1000 reis
Mexico ... ..	Dollar ...			c	100 centavos
Paraguay ... ..	Peso ...			d	100 centavos
Uruguay ... ..	Peso ...			d	100 centavos
Venezuela ... ..	Bolivar ...	1·894	0·52 $\frac{13}{16}$	a	100 centavos

Table 24—Currencies of some countries, with their equivalents.—Contd.

Name of country.	Currency.	Value per rupee	Value in rupees.	Class	Minor coins.
<b>AMERICA—contd.</b>					
Jamaica ... ..	Sovereign	0·075	13·33 $\frac{1}{3}$	b	20 shillings
Peru ... ..	Sol	0·912	1·00 $\frac{19}{82}$	d	1000 centavos
<b>AUSTRALASIA—</b>					
Australia ... ..	Sovereign		13·33 $\frac{1}{3}$		20 shillings
New Zealand ... ..	Sovereign	0·075	13·33 $\frac{1}{3}$		20 shillings
<b>EUROPE—</b>					
Great Britain . .	Sovereign	0·075	13·33 $\frac{1}{3}$		20 shillings or
Spain ... ..	Peseta				240 pence
Switzerland ... ..	Swiss franc	1·892	0·42 $\frac{2}{3}$	d	100 centimos
Yugoslavia ... ..	Dinar			a	100 centimos
Denmark ... ..	Krone			b	100 paras
Norway ... ..	Krone	1·362	0·73 $\frac{7}{18}$	a	
Sweden ... ..	Krone			a	100 ore.
Austria ... ..	Schilling			a	
Belgium ... ..	Belga	2·594	0·38 $\frac{8}{17}$	a	100 groschen
Holland ... ..	Guilder	2·625	0·38 $\frac{8}{17}$	a	5 belga or 500 cents
France ... ..	Franc	0·908	1·20 $\frac{1}{2}$	a	100 cents
Germany ... ..	Reichsmark	9·315	0·10 $\frac{1}{2}$	a	100 cents
Italy ... ..	Lira	1·532	0·65 $\frac{8}{17}$	a	100 pfennige
Greece ... ..	Drachma	6·935	0·14 $\frac{1}{17}$	a	100 centesimi
Hungary ... ..	Pengo	28·125	0·03 $\frac{8}{17}$	d	100 leptae
Poland ... ..	Zlotv	2·087	0·47 $\frac{8}{17}$	b	100 filler
Portugal ... ..	Escudo	3·253	0·30 $\frac{1}{2}$	b	100 grosz
Turkey ... ..	Turkish £	0·338	2·95 $\frac{1}{18}$	d	100 centavos
Czechoslovakia ... ..	Krone	...	...	d	100 piastres
Russia ... ..	Tchervonetz	12·319	0·08 $\frac{1}{2}$	b	100 heller
		0·071	14·02 $\frac{1}{18}$	d	10 roubles

chiefly notes issued by Barclays Bank and the Government of Kenya Colony. Indian rupees and British coins also circulate freely.

(f) PALESTINE. Being recently released from the British mandate, its currency has been fixed as the equivalent of the British Pound. It is divided into 1000 mils for smaller currency.

(g) PERU. The Peruvian Pound or Libra is in theory like the Palestine Pound, equal to the British sovereign but the notes of the Reserve Bank of Peru have, for a long time, been quoted at a discount. The new unit, the sol, has also become inconvertible.

(h) STRAITS SETTLEMENTS. The currency is the Straits dollar which is maintained by the exchange standard at a value of 28d. per dollar. It has sometimes deviated from this ratio but not very much, and when sterling was off the gold standard so was the Straits dollar.

## II. The United States and associated countries.

The currency of the United States consists of a very small number of gold coins, 900 fine, valued at \$20.67183 per oz., and of two series of note issues. The first is the gold certificate issued against full gold backing and the second is the Federal Reserve Note with a minimum of 40% backing. There are also small amounts of silver certificates, National Bank notes and survivals of the famous "Greenbacks" from the Civil War days. The total volume of currency is estimated at more than 5000 million dollars. There are gold coins of 2½, 5, 10 and 20 dollars, with small silver and nickel coins. Some old silver dollars also circulate and are redeemable in gold. Gold dollars, especially 5 and 10 dollar pieces, are in demand in the Punjab and Bombay side chiefly, perhaps, on account of the beautiful 'Liberty' head on them.

(a) CANADA. Being so near the United States, its currency is the same as the U. S. dollar and not the sterling pound. For some years there was a good discount on Canadian dollars, sometimes as much as 1¼%, but they returned to par. The paper currency consists of some government issue, and of the banks which are all chartered, with power to issue notes.

Consequently, no foreign bank is allowed to operate, as it is almost impossible to obtain a charter. Barclay's Bank, (Colonial, Overseas, and Dominions) is the only one in operation and even it had considerable trouble in obtaining the charter. Side by side with the Canadian 5 and 10 dollar pieces, the sovereign and U. S. coins circulate.

(b) CUBA, LITHUANIA, NICARAGUA, GUATEMALA. These countries adopt the U. S. Dollar more or less. In Cuba, the *martí* is 20 dollars ; in Lithuania, the *litas* equals 10 cents ; in Nicaragua, the *Cordoba* is one dollar ; and in Guatemala, the *quetzal* is one dollar. In the last two countries the actual currency is inconvertible paper notes. The other two maintain exchange standard relations.

### III. The Latin Union.

(a) SWITZERLAND. Alone among the members of the Latin Union, Switzerland survived the shocks of war, chiefly because it was a neutral country. But it could not be completely free from them and its currency depreciated in the postwar period by 14% in 1920. In 1922, it fully recovered and has been on the gold standard since then. In some years it was even at a slight premium over gold. This brought into the country all the gold coins in the other members of the Union and in 1926 the Swiss National Bank had nearly 100 million francs worth of them. Its notes are now backed by 65% of gold and 35% of foreign balances.

(b) FRANCE. France was the principal member of the Latin Union and it went far away from it in the postwar period, the franc being quoted at one time as low as 250 per pound, or  $\frac{1}{16}$  of its prewar value. When the reorganisation of the currency was started, it appreciated in 6 months to 124 per pound and it was stabilised at 124.21. Hundred franc pieces are minted if required, but the currency is chiefly Bank of France notes. The gold bullion standard is in operation, but the minimum amount redeemable and the rate are settled from time to time by consultation between the Bank of France and the Finance Minister.

(c) THE COLONIES OF FRANCE are all on the gold exchange



standard with it. They are Algeria, Belgian Congo, Morocco, Tunis and Madagascar in Africa, and Indo-China in Asia. In Indo-China, the sole right of note issue is with the Banque de l'Indo-Chine and, though it is expressed in francs, it is payable in local silver piastres at 10 francs per piastre.

(d) LATVIA, ALBANIA, MONACO, SPAIN AND YUGOSLAVIA, are now on the same standard with Switzerland. The Dinar of Yugoslavia is inconvertible paper notes. Spain has a note issue which is covered by a reserve of gold of 60% but, owing to lack of self-confidence on the part of the Bank of Spain, the peseta has been gradually depreciating and stood at 45 per pound in April 1931 and, after the abdication of King Alfonso, it stood at 56 to 60.

(e) BELGIUM, another member of the Latin Union, had the same fate as other belligerents in the War and its currency depreciated to 175. When it was stabilised, a new coin, the Belga, worth 5 francs was introduced. The currency is bank notes issued by the Bank of Belgium.

(f) ITALY, the other important member of the Latin Union, also suffered and, at one time, the lira was quoted at about 130 per pound. But the 'strong' Government of Signor Mussolini restored it to stability at 92.46, the Banca D'Italia having the sole right of note issue. Tripoli, its colony, has a lira exchange standard.

(g) GREECE has never been really on the gold standard in practice. In theory, it was a member of the Union up to 1928. But inflation and depreciation made it always something of an interloper. In that year the currency was stabilised at 375 per pound, and now stands at that level.

**IV. The Scandinavian Union.** The Scandinavian Union consisting of Norway, Sweden and Denmark (and, latterly, Iceland and Esthonia), have a currency, which also has survived through the war on account of their neutrality. They are all on the gold standard though they were off it for a short time. They have 20 kroner, 10 kroner and 5 kroner gold coins of 900 fineness with a weight which gives a parity of ₹8.159 kr. per £. The notes of one country are not, however, interchangeable now, though this was one of the principles of

the Union from its formation in 1873 and reaffirmed in 1924 ; but the gold coins are interchangeable. Swedish notes are now convertible into gold coins, but Danish and Norwegian notes are not. Esthonia, which is a postwar State, first tried the mark as currency but changed to the kroon in January 1928. Iceland, one of the earlier members, had to lose control over the currency and, from 1925, it has been away from the Union for all practical purposes.

**V. Germany** adopted the gold standard in 1871 with 10 mark and 20 mark coins with 900 fineness, giving a parity value of 20.43. As a result of the war and the occupation of the Rhine and Saar valleys, its currency depreciated so rapidly that when one heard of a certain rate even so near as in London, it had actually changed by another 5 or 10%. Exchange on Germany was for some months purely nominal, being quoted at one time at Marks 103,741,900,000 per pound sterling. And the note issue was Marks 497,000,000,000,000. As a result of this, new currency units were introduced with ratios near limits of credibility. The Renten-mark and the Boden-mark, in turn, passed into oblivion. Finally, a new Reichsmark was introduced in 1925 under the Dawes Scheme and the stabilisation loans. This proved rather weak on account of the size of the Reparation instalments and it was further strengthened by a re-allocation of the payments, under the Young plan of 1929. The Reichsmark is officially of the same value as the old mark and has been maintained at that rate until July 1931, when the temporary suspension of the Darmstädter Bank sent it down to 31 marks per pound ; but the Government action and the international support of the mark brought it back soon to normal value.

**VI. Austria** has been culturally allied to Germany and, since the war, its other component members, the Magyars and the Poles, have been separated. The gold standard adopted in 1892 provided for krone or corona which were near the mark in value, being 3280 krone to 3100 marks. In the postwar period the krone was also quoted like the mark because it was a "vanquished" currency. In 1925, the League of Nations started to stabilise the currency on the basis of the schilling

at a parity of 34.58½ per pound. It has been stable at this value since then, though it had to appeal to England early in 1931 and to the League of Nations since then.

**VII. Hungary** which was separated from the Dual Monarchy of Austria in 1918 found itself with a heavily depreciated currency which was reorganised in November 1925 on the basis of the pengo which was made equal to 27.825 pengos per pound on the exchange standard.

**VIII. Poland** had a Polish mark which depreciated heavily during the war and after, and in 1923, a new unit, the zloty, was introduced with the value of the Latin standard of 25.22 but it soon collapsed and had to be revalorised at 43.38 on the exchange standard. The legal tender is note issue of the Bank of Poland.

**IX. Holland** (Netherlands or Pays-Bas, as it is called) entered the gold standard in 1872 when ~~the~~ silver was demonetised. Holland remained very near the gold standard all through and recovered very quickly because it was neutral, because it was the link between the belligerents and also because it was the refuge of many belligerent nationals. In 1927 the Netherlands Bank, oppressed by the heavy influx of gold, had to reduce its buying price so that the notes stood at a premium above gold. The florin or guilder is issued in ten-florin pieces weighing 6.408 grams of pure gold—a parity value of 19.82 pence.

JAVA has a note issue linked with the Dutch florin but gold coins are also in circulation. The exchange standard has worked very well and parity has generally been maintained.

**X. Portugal** came on the gold standard in 1855 with a coin of ten milreis for 17.735 grams  $\frac{1}{2}$ ths fine. At present, gold is not in circulation and the notes are inconvertible. The mint par of the escudo, the new unit, is 4.50½ but it now stands at about 108 per pound.

**XI. Russia** is a country about which it is considered not safe to say anything definitely. The internal currency is paper notes which are not related to gold; but, for international transactions, there is the Tchervonetz of ten roubles and their exchange value is being maintained by the Russian

Bank for Foreign Trade. The rate on Moscow is quoted at near 9.46 per pound.

**XII. Turkey** was another of the belligerents which lost heavily because it was defeated. The Turkish piastre is related to a theoretical gold lira of 100 piastres which should be equal to £909 or T. £110 per 100 sterling. It now stands at nearly 1025, nominal quotation.

**XIII. Japan** adopted the gold standard in 1897, the gold yen being the equivalent of  $24\frac{1}{2}$  pence, just less than half a United States dollar. The Bank of Japan has the right of note issue but it is believed that it does not enjoy the co-operation of the commercial banks which have sometimes even flouted it, the reason assigned being chiefly that they do not maintain any balance with the Central Bank, whose rediscount rate is, therefore, not always enforceable on the market.

**XIV. China** has a silver standard. The chief centres of contact with the outside world are Hongkong and Shanghai. The former has note issue of the privileged banks and the latter has silver taels weighing about 1.18 ounces pure silver. But the internal currency is so disorganised that one never knows what tael he has to reckon with. Like the famous "cat" of the dungeon-keepers of the Middle Ages, China has nine taels, though some think there are many more.

**XV. Persia** is theoretically on the gold standard with a kran which is issued in coins of gold and silver. The note issue privilege belonged to the Imperial Bank of Persia, which is a British concern. It obtained a renewal of this right in 1924 for 25 years but in 1928 it was decided to buy up this privilege in 1931 at a cost of £200,000 and remission of royalties on existing issue. A National Bank was to be started by pledging, if necessary, the crown jewels as security. The currency, however, is not usually quoted in other centres.

**XVI. Siam** has the tical currency which is related to sterling on the basis of an exchange standard at 11 ticals per pound sterling.

**XVII. Egypt** (and the Sudan) have an Egyptian pound which is related to sterling at  $97\frac{1}{2}$  piastres per £. Notes issued by the National Bank of Egypt are now the only legal

tender and are sometimes at a slight discount. The Egyptian pound, both as regards the unit which is exactly five dollars and as regards the division of that unit into 100 piastres, is more akin to the dollar than to the pound whose name it bears.

**XVIII. Argentina** has a paper currency, the unit being equal to 44 cents gold. Quotations are made on the basis of the peso oro (gold peso) of 100 cents but payments in the country are made in paper pesos which were stabilised in August 1927 at this level. But they have now moved from that and are quoted at about 16% discount.

**XIX. Brazil** has the milreis (1000 reis) which has a gold relation of 27 pence per milreis. But, like the Argentina currency, the note issue is inconvertible. When it was stabilised at 16 pence in 1910 it was thought it would stay there, but it depreciated and, according to the new law, the cruzeiro of four paper milreis is proposed. The law could not be put in practice because the milreis has further depreciated to  $3\frac{1}{2}$  pence. Large amounts in Brazil are quoted in terms of the "conto" of 1000 milreis which is worth about £14-12-0.

**XX. Mexico** has a nominal gold standard but the actual dollar in use is a silver one. The Mex. Dollar, as it is called, circulates freely in China and some other countries in Asia and its value, like that of the tael, fluctuates with the price of silver. After various revalorisations, it is now stabilised at 9.76 pesos per pound but even this is very unstable and is quoted at about 10.30.

## CHAPTER XXXVII

### THE RESERVE BANK OF INDIA.

*"My ideal is not to make money, but to render service"*

External price stabilisation—Control over banks—Any ratio will do—Effect of ratio on gold reserves—Gold coin standard—Closer limits of movements—Local securities.

The Reserve Bank in India will have two functions, one being the control of internal credit and currency, and the other, the regulation of the external value of the rupee. It cannot be said that these two functions are entirely independent,

because internal prices do affect the exchange rate or the external value of the rupee, and external prices also affect the internal prices through the exchange rate. As internal prices depend to a large extent on the volume of currency and credit there is an inter-dependence between currency, credit and exchange rates. If the Reserve Bank should consider its chief function the internal stabilisation of prices, it will find that the external value of the rupee will be out of touch with international prices with the result that there must be fluctuation, sometimes even violent, in the exchange rates and the Reserve Bank would lose control even over internal conditions. Similarly, if the Reserve Bank should concentrate its efforts mainly on maintaining a stable exchange rate through its management of the gold assets, leaving internal credit and currency to be managed by the other banks, there would again result the same disequilibrium between internal and external prices, which would unsettle the exchange rates.

In carrying out this policy, the Reserve Bank will have two disabilities. The first is that, if it is a shareholders' bank it will have two conflicting interests, those of the shareholders desiring high profits and the national interests calling for efficient but cheap service. If it is a State bank, there would again be the conflict between its trusteeship to the nation and the political interests of the Government or the party in power. Granting that it manages to steer clear of these dangers there are other rocks and shoals ahead. It will find that, in carrying out its policy, it must have the co-operation of the commercial banks. When it proposes a high rate, they will gladly follow it. When it proposes a low rate, their profits are in danger, and they might try to nullify its policy. The Reserve Bank must, therefore, have resources enough to bring the commercial banks to reason. Its most formidable rival in this is, of course, the Imperial Bank of India with its 11 crores of capital and reserves, its 70 to 80 crores of deposits, and its majority of foreign shareholders. Next come the foreign banks about whom Mr. A. S. J. Baster writes as follows in "The Imperial Banks":—

"The exchange banks form a relatively unabsorbable and uncon-

controllable part of the Indian banking system . . . . The exchange banks do attract Indian deposits but, on account of their specialised business, drain all the money to the ports in the busy season, when it is quite as much in demand up-country" . . . . "It may well be asked whether the Reserve Bank of India or the South African Reserve Bank will not find their operations hindered by the presence in the local banking system of very large and powerful institutions, with shareholders, direction and financial support coming from a centre altogether external to the Central Bank's own sphere. To escape the Central Bank's penal rate of rediscounts, all these banks would go to the London market, or the Bank of England and, short of a very thoroughgoing form of co-operation between the Bank of England and its prototypes in the Dominions and India, no local Central Bank can stop a practice so obviously fatal to its assumption of money market control. "

There are in circulation in India at the present time about 160 crores of currency notes printed on paper and about 190 crores of currency notes printed on silver. Neither of these have any permanent intrinsic value for the purpose of our exchange relations. They are both token currency and depend for their value on proper control of their volume. Therefore, there is no 'natural' exchange ratio for the rupee in relation to gold currency. It is true that, over a series of years, Government were able to maintain it about 16*d.* ; but, during the war, it moved away from that ratio and touched 34*d.* and then began to fall, when it was stabilised at 24*d.* but again receded to 15*d.* and has now been officially revalued at 18*d.* If the present ratio is worked sufficiently long, it might, perhaps be accepted more and more as approaching to the 'natural rate' ; but the point in question is that, whatever be the rate of exchange at which the rupee is legally stabilised, it must be an arbitrary one, because there is no intrinsic merit in the rupee which would correspond to the relation between the gold sovereign and the gold dollar, which are both coins of the same material.

So long as an arbitrary value is assigned to the rupee, it would not materially affect the situation as regards the balance of trade, the purchasing power of the agriculturists or the country's international credit, when once the adjustments to this arbitrary rate have taken place ; and it would not matter for the purpose of the argument whether the rate be fixed too

high or too low. But the introduction of another ratio must once again disturb our international relations and dislocate our commercial relations with other parts of the world, both as regards our capacity to purchase other goods and our efficiency to compete in selling our products. If the new rate of exchange is higher than the present one, our internal prices will be higher than those of other nations, and we shall be cut off from the markets of the world. If the new rate is, on the other hand, a lower one, our internal prices will be lower than those suggested by the exchange rates, and prices will become uneconomic for producers ; and, unless the Government interferes very actively again, the rate might move back to 18d. through a curbing movement on exports or imports.

It may be claimed that the exchange rate will have a certain use in determining the sufficiency of the gold assets of the Reserve Bank. With a note issue of 160 crores, the Bank would require about 80 crores of gold and gold assets to start working. At 18d. per rupee this would be £60 millions, of which £40 millions is in the Gold Standard Reserve, and £20 millions must be found from the gold assets of the Paper Currency Reserve or other sources. If, on the other hand, the rate was assumed at 16d., 80 crores would be equal to about £53 million, of which £40 millions being in the Gold Standard Reserve, only about £13 millions need be found from other sources. This is quite true. But it is true only to start with. As soon as the new ratio is put into operation, rupee prices must necessarily rise and the volume of currency that is sufficient for the needs of the country at 18d. ratio will be much less than the volume required on the basis of 16d. Just as prices fell down by about 12% when the ratio was changed from 16 to 18d., and currency was contracted by about 40 crores, prices must rise by the same amount when the ratio is changed back again and the total money required for internal use will also change and, instead of 160 crores of paper currency and 200 crores of rupees, we would require about 200 crores of notes in addition to 200 crores of rupee coins. The gold reserve of the Reserve Bank will ultimately have to be 100 crores or £67 millions which is £7 millions more than what is required



on the basis of the 18*d.* ratio. Ultimately, therefore, it would appear that it would be better for the Reserve Bank to continue with the existing rate.

It must also be remembered that the raising of the exchange ratio from 16*d.* to 18*d.* did incidentally help to balance the budget, because the rupee equivalent of our foreign payments became less, due to raising the external value of the rupee. Now if the process is reversed and the rupee is reduced to 16*d.*, the external payments will be increased in terms of rupees and the budget must again show a deficit to that extent. The annual remittances of the Government of India total about £40 millions which, at 18*d.*, amounts to 53 crores, but, at 16*d.*, it would amount to 60 crores. The Finance Member will then have to find another 7 crores if he is to balance the budget with a 16*d.* ratio.

It has been suggested by some economists that, as we are chiefly concerned with the production and distribution of commodities for local use, we might as well regard it as the primary function of the currency authority to maintain internal prices and leave it to economic laws to maintain the external value of the rupee at any level they can. This theory fails to take note of at least four factors in the situation.

First, the total of our foreign dealings is not so negligible that our internal prices will be the dominating factor. The production of goods for internal consumption is estimated at about 1200 crores annually, while exports and imports total 600 crores on an average. This, of course, does not compare with the United Kingdom, for example, which is almost wholly a manufacturing country and with exports several times more than internal consumption. The mills of Lancashire, the coal-fields of Wales, the iron and steel works of Sheffield and the machinery-making machines of Birmingham, all work to produce exportable commodities. From this difference arises the psychological effect on the people's attitude towards the external value of the local currency. A slight variation, say  $\frac{1}{16}$  point in the London-New York rate would immediately create apprehensions in London and cause for comment and action by the authorities. In India, on the other hand, a movement

of even  $\frac{1}{8}$  of a penny in the rate, or nearly  $\frac{3}{3}\%$ , does not attract so much attention from the general public. This, however, is no excuse for denying the importance of the exchange rate.

Secondly, most of our exportable commodities have to compete with the products of other countries and must, in consequence, be maintained at prices equivalent to those at which others are prepared to sell. The price of the exportable surplus thus fixes the price for internal consumption, so long as the Government does not give bounties to exporters which would enable them to compete with other producers even when internal prices are higher. Even in the case of our monopoly product, jute, we are unable to demand our prices as was shown by the tumble down of jute prices in 1929 and 1930 when it fell from Rs. 9/- a maund to Rs.  $\frac{3}{8}$  a maund.

Thirdly, so far as our imports are concerned, the prices are determined by outside factors and, as our imports are nearly 250 crores, we have to export produce to the equivalent of this amount. If, however, internal prices are low, we shall have to export more goods than if we maintain our prices on the level of the rest of the world. On the other hand, if our prices are too high, our exporters will be shut out and it will be impossible to balance our foreign trade.

Fourthly, there are the Government remittances for which the exchange rate is very important in determining the balancing of the budget. In view of the fact that we depend to a very large extent on our foreign trade in remitting against our foreign obligations, the rupee must be maintained at a fixed relation to gold. If this is done we shall not have to drift away from the world at large but, on the other hand, we shall secure for our internal prices a movement corresponding to that of the rest of the world and, through international co-operation, we may attain that stability of internal prices which is the millenium of these economists.

It is not possible, or fair, under present conditions, to insist on any ratio as being "natural" or proper or consistent with Indian monetary arrangements. As pointed out elsewhere, the decline of our gold assets cannot be attributed

solely to the 18 pence ratio, as it is largely due to the fact that the Government's operations as borrower in India and England, as a buyer of sterling, and as currency and exchange authority have been too much mixed up. The proper thing to do is to start the Reserve Bank and let it decide whether the present ratio is workable. If it finds it difficult to maintain its gold assets on account of the ratio, it will appeal to the Government to suspend the ratio, in just the same way as the "National" Government was asked to authorise the Bank of England to suspend the redemption of its notes in gold, in September 1931. There would not then be any criticism that the change is being proposed by interested parties.

Assuming that a certain rate of exchange is agreed upon as the one which the Reserve Bank should try to maintain, there are two ways in which the relation might be established. A gold coin might be introduced to signify this relation, and it might be made unlimited legal tender in the country, with note substitutes and rupee subsidiary coins with limited legal tender. But the introduction of such a standard must require very large gold resources in the hands of the Government or the Reserve Bank. For, if the gold coins were not readily available, there would be a discount on the representative note issue and, if gold coins were to be made easily available, the supply will have to be large enough to meet the demands of note-holders. Therefore, a good proportion of the 400 crores of outstanding rupee and paper notes will be required in the form of gold and the acquisition of such assets, about 200 crores, may be taken as well-nigh impossible.

The second method would be an arbitrary legal relation between the rupee and the pound sterling, with import and export parity values estimated in just the same manner as if we had gold coins, coupled with an obligation on the Reserve Bank to buy and sell gold at these prices. On the basis of the legal ratio of 18*s.* the Hilton Young Commission recommended an import parity value of 18½*s.* and an export parity value of 17½*s.* While the import parity would apply to gold, the export parity would apply to gold or gold exchange at the option of the Reserve Bank. This may be in force for the

first few years because, constituted as it will be, with a comparatively low gold reserve and with a high proportion of its assets in the form of sterling balances, the Reserve Bank cannot afford to decrease the gold assets by allowing exports of bullion, though it would gladly welcome increases to it through imports. We have seen that postwar gold standards have been thus interpreted and a gold standard for India might be equally operative as in other countries. The introduction of a gold coin is, however, desired by many people on sentimental grounds, as they believe that its free circulation will popularise the rupee as being really linked with gold.

While it is possible to appreciate the feeling that the nation has suffered in international circles by not being on the gold standard, it is not easy to follow the arguments for a gold coin. It has been the tragedy of India that educational, financial and all kinds of theories are experimented upon here just when they are being discarded elsewhere. It would be a pity indeed if the nation should commit itself to a similar policy with regard to gold coins for the reason that, in 1913, there were gold coins in other civilised countries. But in 1913, India worked quite satisfactorily on the gold exchange standard. When we desire to move with the rest of the world and adopt a gold standard, we must move with it also in adopting the fundamental concepts underlying the present day gold standard in theory and practice ; and the most essential feature of that standard is that gold coins play no part in the operation or efficiency of the system.

It is not as if India does not appreciate the value of notes as efficient substitutes for token currency, or for the real money. It has till now been the custom of the Government to issue notes against silver coins and since, in the eyes of the people, the rupee is only an arbitrary standard of value, they have been prepared to take it in the form of the paper note. But too hasty an introduction of the gold note even by the Reserve Bank might lead to a discount on it, such as obtained during the years 1918 and 1919, when the rupee notes were quoted in the bazaar at so low a rate as 80% of their face value.

There is another aspect of this problem which must not be forgotten. Granting that we manage somehow to introduce about 200 crores of gold coins against a total circulation of 350 crores, what is the guarantee that it will be used as money and not as a commodity? From the volume of gold imports we have seen that a good portion of it comes as coins and that they circulate quite freely in the country, but are not used as coins and are often melted to make ornaments. The same fate might overtake gold coins introduced in the country by the Reserve Bank. People with money to invest in jewellery might make a raid on the gold resources of the Bank by insisting on redemption of notes or silver in gold, and the coins might disappear, so far as the monetary supply of gold was concerned.

If we understand the purpose of the gold standard as essentially to link the rupee with other currencies in a fixed ratio, a theoretical rupee worth 18d., or whatever ratio is decided upon, would work as well as an actual coin, with the advantage that, for purposes of foreign trade, gold or gold currencies will be more readily available from the Reserve Bank working on a gold bullion standard than from the general public if the country has gold coins. Even in the United States, the dollar is an ideal gold coin since the war. But everybody accepts the paper notes as being just as good as the gold dollar. Giving evidence before the Hilton Young Commission, the Governor of the Bank of England stated that he did not expect to see in his own life-time gold coins in circulation in England. Therefore, if the Reserve Bank honestly works the bullion standard, it would place India on as effective a gold standard as any other country.

The Reserve Bank will then have the legal obligation to purchase and sell gold or gold exchange at the two points but it will not necessarily confine itself to these limits. At present, the work of tiding over adverse or favourable balances of trade in ordinary years is the work of the banks and the actual balancing of our payments abroad is made by forcing the exchange rate up or down. If the movement in the rate does not balance them, the foreign currencies are bought by the

banks in years of plenty and exchange is sold in lean years. These funds would accrue to the Reserve Bank in future, and it would not normally allow the rate to fall below  $1/5\frac{3}{8}$ , or go up above  $1/6\frac{1}{8}$ . It may even be that, in ordinary years, the rates may be confined between  $1/5\frac{1}{8}$  and  $1/6\frac{1}{8}$ . When the rate touched the upper limit, the Bank would buy foreign currency, and at the lower rate it would sell foreign currency. In these circumstances, there would attach to the bank rate in India and to the gold holdings of the Reserve Bank, an importance approaching to other countries.

\* The difference between the legal obligation and the moral obligation of Central Banks was thus explained by Mr. R. G. Hawtree in an address before the London Institute of Bankers (Journal, February 1927):—

The Central Bank's task is to keep the value of the monetary unit in the foreign exchange market as near as possible to par with gold standard currencies. Any considerable failure in accomplishing this purpose will involve it in a gain or loss of gold both larger and more sudden than any movement to, or from, internal circulation. In settling the amount of the gold reserve, these international movements must be the main consideration. Obviously, the loss of gold is a much more serious matter than a gain. If the Central Bank receives an abnormal amount of gold, it suffers a diminution of profits and, possibly, a loss of control over the market in discounts and short loans. But the loss of control, leaving the community free to borrow and lend, will tend to cheapen the currency and to restore equilibrium, and the restoration of equilibrium will itself enable the Central Bank to get rid of the superfluous gold.

On the other hand, a loss of gold may exhaust the reserve altogether, and incapacitate the Central Bank from discharging its duty of selling gold at a fixed price. That means an actual lapse from the gold standard and a reversion to the system of maintaining equilibrium in the foreign exchange market by letting the rates of exchange vary.

The Reserve Bank will have the same four methods of influencing the rates as other Central Banks, namely, movements in the discount rate, variations in the volume of currency, borrowing or investing abroad and movements of gold to and from the country. It would try to avoid the last remedy by selling or buying gold currencies. The Reserve Bank's purchases and sales would have a long period effect in addition to the immediate effect resulting from the sale of exchange. When a commercial bank sells exchange, there is

a transfer of bank cash from one member of the public to another without a change in the outstanding volume of currency. But when the Reserve Bank sells exchange, the cash resources of some bank are decreased and both currency and credit in the country decrease, which in turn, would tend to steady the exchange rate. Similarly, the purchase by the Reserve Bank would not only ease a high rate immediately but, by increasing the volume of bank cash, currency and credit, would tend to bring down the high level more permanently.

One of the conditions imposed upon the Reserve Bank so as to prevent the gold assets from depreciation is to prohibit its lending to the Government of India beyond the limit of 50 crores. It might be argued that the credit of the Government of India is just as good as that of the other countries and that its securities are full value for note issue backing. If we remember that securities are a form of Government borrowing, we shall see that these assets will be most unreliable just when they have to be realised in times of panic or lack of confidence. The Reserve Bank is a trustee on behalf of the people and it must see to it that neither the Government nor any public or private body or individual, for that matter, is allowed to make use of the Bank to an undue extent. Issuing notes against local securities is the same as a client who, when asked to repay an overdraft, gives the bank a cheque on that very account! To this doctrine Kisch and Elkin pay tribute when they say\* :—"Again, a limit should be placed on the amount of Government securities taken as collateral. These are, in practice, likely to predominate among the securities offered as a basis for loans and it is important that they should not be permitted to obtain a position in the Bank's business which might lead to the subordination of credit policy to State exigencies."

In order to make its policy successful with regard to the stabilisation of the rupee, the Reserve Bank must have the closest co-operation of other Central Banks, particularly the Bank of England. This does not mean subordination to it, as

\* Central Banks, p. 131.

suggested by the Government of India despatch on the Simon Commission Report. It means that the Bank of England will give the Reserve Bank such assistance as it may require in carrying out its policy. If it is trying to restrict credit, it should not be possible for other banks to borrow in London and bring funds into India. The Bank of England may, in such cases, have to bring moral pressure to bear on banks lending for such purposes, in the same way as it does in times of financial stringency in England.

Again, if the Reserve Bank should require temporary accommodation in London, it could not borrow in the open market without loss of prestige and the Bank of England might well consider the possibility of lending at special rates to the Reserve Bank. Central Bank co-operation with the Reserve Bank might be furthered by its becoming a shareholder of the Bank for International Settlements. It has on its management the men in charge of most Central Banks of importance in the world, and it will be found that the prestige and standing of the Reserve Bank will be increased by association in the "B. I. S."

## CHAPTER XXXVIII

### RUPEE BILLS AND ACCEPTANCES.

*"I beseech your good word and no more"*

Acceptance bills—Lend credit rather than cash—Export acceptances—Rupee bills—Shifting the clearing centre—Why stimulate imports?

Acceptance bills in connection with foreign trade are fairly common in most countries. In India, however, owing to the peculiar monetary conditions, the foreign trade has been receiving its local finance through the system of each credits in the same way as internal trade. When an exporter has purchased goods and they are awaiting shipment, he is generally able to obtain an advance from his bank in the port towns on condition that he promises to sell his documents covering the shipment, to that bank. This, in effect, is an agreement



that the exporter would hold the goods in trust for the bank from the time of the advance and that, before he disposes of them to third parties, he should settle the claim of the bank. He is usually charged interest at the Imperial Bank of India rate with a minimum of 6% or, sometimes, 1% above, with a minimum of 7%. The bank would advance about 50 to 90 per cent. of the value of the goods and, if the goods are stored for a long time, and they deteriorate much in value, it would ask for further security or for a reduction in the amount of the advance.

In other countries, the advances are obtained by the exporter through arrangement with his bank to accept his drafts on it for the sum required. The accepted drafts are then placed in the local discount market and he obtains the advantage of the cheaper rate in that market as against the rate chargeable on loans. Thus, if there had been a discount market in India and acceptance bills were drawn, the customer, instead of having to pay 6%, could easily obtain his advance at about 4%, which is slightly above the rate at which the banks borrow from the public. When the goods have been shipped and the documents have been negotiated, the funds would be paid over to the accepting bank for meeting the bills. The bank, in this case, does not lend the customer the actual cash but gives him the benefit of its credit to borrow from others. For this service, the bank would make a small charge of about  $\frac{1}{18}$  % per month.

Acceptance bills could also be created for financing exports between the time of shipment and the return of proceeds. This is easy if the export bills are drawn in local currency. But, even for other bills, the bank which collects the bills could accept new rupee bills in their place and the duration of these bills would correspond to the time taken for the proceeds to come back. This is the process adopted in France by the French National Bank for Foreign Trade. If, for some reason, the funds are not returned within the stipulated period, new bills could be created for retiring the old ones. This system can be popular only in such places where the discount rate is as good as can be obtained for sterling, which is generally

chosen for foreign trade. America has the New York discount market which is as efficient and as cheap as the London market. Amsterdam has got its own market and Japan has the special system of "stamped bills" by which, when necessary, the exporter is enabled to borrow cheaply in the local market. France, which has had so much surplus money returned from other countries, is organising a discount market.

Acceptances might also arise in connection with the import trade. When such a bill comes into India, drawn in sterling, the importer and the holding bank could co-operate to place it on the market by drawing another rupee bill which the importer would accept. It is thought by some that such bills would release the other parties to the original bills, but the better opinion seems to be that they will not. Even if the doubt is justifiable, the Government could easily amend the Act to provide for such bills to be drawn. If the exchange banks will not co-operate with the importer, the acceptance bill would come to his help. He would take some securities to his bank and ask it to accept a bill drawn on it and the bill could be used to retire the foreign bill. He would then have to pay only the lower rate of the discount market and, when he is in a position to pay for the import bill, he would place the funds with the accepting bank to retire the acceptance bill. If the importer sells the goods against trade bills, he could use them to provide funds for meeting the old bill.

Under present conditions, acceptance bills in India may become popular in connection with the export trade for the period between purchase of goods and shipment from India and, for the import trade, for the period between acceptance of the foreign bill and payment for it. Such acceptance bills can thrive only with the fostering care of a Central Bank. The best illustration of this is New York where, till 1913, acceptance bills were practically unknown. Trade bills in fairly good volume used to be discounted by the banks, but the lack of rediscount facilities made them conservative in lending on bills. In 1916, three years after the creation of the Federal Reserve Banks, acceptances amounted to \$250 millions, and in 1919, they were over \$1,000 millions. During

the deflationary period, the total came down to \$600 millions, but in 1926, it was \$755 millions against \$575 millions of trade bills.

Until a discount market is organised, these bills would be purchased by the banks and the rate of interest might be no better than the bank rate. To this extent, the cash credit system will continue to be popular. But, if the Reserve Bank will adopt the suggestion of the Central Banking Committee, that it should quote a lower rate for bills than for ordinary loans, even against Government Paper, this difference would be passed on to the clients by the banks. It is further possible that banks in India would also compete for the acceptance bills and a group of banks might combine to discredit the paper of another bank by using a discriminatory rate ; for this reason also it is necessary that the Reserve Bank should be on the spot to protect the signatures of such banks.

The use of rupee bills for imports into India was discussed by the Central Banking Enquiry Committee with the foreign experts who thought that the currency of that country would be preferred which is of international value and where there is an organised discount market and the rate is cheaper than at other places. It was rightly pointed out that this would be true only of export bills, but not of import bills on India as they have to be retained here and cannot, therefore, work on the London rate of interest as is possible for countries in Europe. It is true that, in the case of 'House Paper', the bills are discounted in London and the importer benefits by the cheap London rates. But few importers in India can find banks in London willing to accept their bills. And the volume of such paper is also limited.

It would appear that rupee bills would not become popular in Indian foreign trade. In the first place, rupees are not international currency. A bank in Canada, for instance, which bought a rupee bill on India would naturally make a higher charge for buying the rupee bill than for a sterling bill against which it can easily recoup itself by selling on London. Secondly, there is no organised market in India for handling the bills and, thirdly, even if there was a discount market,

the rate could not be better for export bills than the London rate for sterling bills. Fourthly, the sterling bills give an excuse for the exchange banks for holding them in portfolio, a right they could not claim with rupee bills. Lastly, there are no Indian banks which could popularise rupee bills as the American, Japanese and British banks are doing for bills in their own currency.

One effect of the rupee bills would be that the centre of interest would shift from India to other places. At present, all bills in sterling are converted into rupees in India and the various sterling rates in the country are fairly in consonance. The diagram below shows that the rupee bills would make the conversion go off to London, New York and other centres. If we have rupee bills both for import and export trade, the result might be even worse.

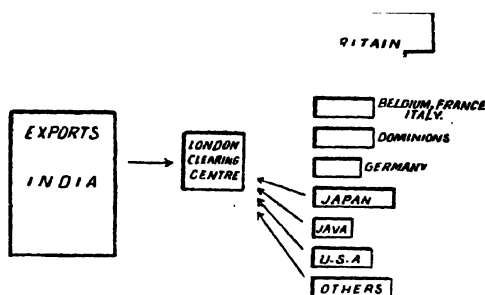


Diagram 10—The clearance of sterling export and rupee import bills.

There would also be the difficulty brought out before the Central Banking Committee that most bills on India are drawn on D/P terms and these bills would not be available for the discount market. Until the credit of Indian merchants improves to such an extent that D/A terms would be allowed to them, the rupee bills would be a hindrance than a help to the discount market. So far as the importers are concerned, the cost of accommodation would not become less than now. If substitute bills are to be drawn to make these bills available to the discount market, then it does not matter much whether the original bills are drawn in sterling or in rupees.

There is another aspect to this question. So long as our exchange business is handled in India, we may expect that some day an Indian bank would get some portion of the business. But, if rupee bills are drawn, and the centre shifts from India, there is almost no chance of any Indian bank getting into this business, because it will have to compete for it in foreign centres, with banks already well-established there.

The reason why dollar and yen bills are popular is that they are intended to stimulate the export trade, the promotion of which is considered as co-extensive with the problem of international trade and the burden of the exchange risk is thrown on the importer. But, in India, the rupee bills are desired for imports. They serve no national purpose and the change is sought after more for the sake of sentiment. If it is said that rupee bills would facilitate imports, it seems to be just the reason why one should oppose their introduction. We are so overburdened with the necessity of exporting all we can to pay the interest and other obligations in London, that it is unthinkable that anyone would seriously suggest that the way of the importer should be strewn with roses. The facilities, on the other hand, should be for the exporters who are suffering from several disabilities, if the evidence before the Central Banking Enquiry Committee is to be believed.

The importer does not need this special help. He has not to compete, like the exporter, with other countries. All that he is concerned with is to secure his goods at a certain price and sell them at a reasonable profit. Even when the bills are in sterling, we have seen that, owing to the highly organised forward market here, they are converted, like the export bills, into rupees at the time the orders are booked.

Rupee import bills would also militate against the importers themselves. Our foreign manufacturers who, as we have seen, sell their goods in India through their agents, do so on the basis of sterling, dollar or yen prices. If we insist on rupee prices, then the manufacturers would have to include a good margin to cover themselves against fluctuations in the exchange rates as the quotations and catalogues would have to be prepared several months in advance. Consequently, the

shifting of the burden of exchange to the foreign exporter would result in a double loss to the importer without any compensating advantage.

The financing of rupee export bills would be a heavy burden to the Reserve Bank. On the basis of 5 crores of bills per week, and an average of five months for the return of proceeds, it would require one hundred crores of rupees for financing the export bills. Nor would it be a feasible proposition that the Reserve Bank should lend cheaper money for export bills than for internal trade, for this will mean a tighter internal money market than even now.

Apart from sentiment, then, there would be no advantage in insisting on rupee bills, and against their adoption there are so many disadvantages that it is well worth pondering over. No doubt, where there is real advantage, rupee bills will be used as they are now to a small extent, but as a practical proposition, they will not arise until we have created a very efficient discount market to take care of them.

## CHAPTER XXXIX.

### DEPOSITS OF FOREIGN BANKS.

*"Too much of even nectar may not be good"*

Foreign banks' deposits—Arguments against prohibition—The scarcity of money—Higher rate—Effect on securities—Loss to banking—Effect on exchange.

One of the subjects dealt with by the Central Banking Enquiry Committee was the question of prohibition of deposits in India for the foreign banks. Those who pressed this suggestion were, perhaps, moved more by political considerations than financial or economic reasons and, as the case for the plaintiff was not well put, it was possible to describe it as unworkable and as a measure neither feasible nor advisable. With regard to the latter aspect, it may well be conceded that the form in which it was proposed was almost harmful to the ordered progress of banking in India. A dislocation of about

70 crores of rupees almost all at once must create very unfavourable conditions all over the country because the deposits which the exchange banks receive perform a double work. They are used to finance the foreign trade of India and they are used to finance the connected internal trade, and it would also appear that the exchange banks have still surpluses which they have to invest in purely domestic business.

As has been pointed out by the Managing Governor of the Imperial Bank of India, a drastic change of this kind must mean that the money would not possibly go to any banks except the Imperial Bank of India, which would thus acquire a semi-monopoly of deposit business in India. Even now, with its 70 crores of general deposits it can "snap its fingers" at the Reserve Bank if it so desires, and its position with an additional 70 crores would be such as to force the Reserve Bank to follow its policy rather than have a policy of its own. In fact, it might be a more formidable rival than the Standard Bank of South Africa and Barclays Bank were to the Reserve Bank of South Africa.

As regards the political consideration, it was put in this form. The foreign banks use Indian money for financing the foreign trade of other countries and also use Indian money to foster the trade of foreigners in India. This contention does not seem to be borne out by the facts. It will be seen from the table given in Chapter I that the loans of these banks to Europeans and Indians very nearly correspond to their respective deposits. This point being disposed of, the other question is whether Indians should not take their deposits of about 40 crores to Indian banks and help them to compete with the foreign banks. It is held that no compulsion can be used on the investing public and that they should be free to do whatever they like with their money. This is true with some reservation. So far as the politicians are concerned, it would be *their* duty, and not that of the Government, to persuade these Indian depositors that these funds have a double effect in weakening the Indian banks and in strengthening the power of the already powerful foreign banks. In other countries, "patriotism" of this kind is so effective that foreign

banks rarely get a look-in into deposit business or internal banking. In India, a similar mentality will have to be developed by the politicians.

So far, however, as the justice of the prohibition is concerned, it may be pointed out that control over private individuals even in such matters is exercised by the State in times of emergency. We have only to refer to the policies followed by Germany, France and other countries and even England after the war and even very recently. For example, it is believed that an Indian bank had arranged for overdraft facilities with one of the "Big Five" and that, when the overdraft was availed of, the bank concerned was pulled up by the "Old Lady of Threadneedle Street".

Whether an emergency of such a kind has arisen in India is a matter for the Government to investigate. If we include the Allahabad Bank among the foreign banks, the growth of foreign bank deposits between 1920 and 1929 is as follows:—

*Table 25—Growth of deposits of foreign and  
Indian banks, 1920-29.*

Year (in lakhs).	Foreign Banks and Allahabad Bank.		Indian Joint Stock Banks
1920	..	7,481	7,348
1921	..	8,573	7,063
1922	..	8,442	5,398
1923	..	7,937	3,676
1924	..	7,989	4,594
1925	..	8,000	4,846
1926	..	8,160	5,309
1927	..	7,913	5,403
1928	..	8,233	5,516
1929	..	7,803	5,492

The acquisition of the Allahabad Bank with its nine crores of deposits, now over 11 crores, is chiefly responsible for the increase in the case of the foreign banks; while the heavy fall in Indian banks' deposits in 1923 was due as much to the Alliance Bank scare as to the deflationary policy of the Government. The net result is that, between 1920 and 1929, the foreign banks have had a clear increase in deposits, while Indian banks have suffered a decrease of over 18 crores.



Whether such a change in the venue of deposits is healthy or not will be the most important factor in deciding on the prohibition of deposits.

It is unnecessary to quote the cases of other countries which have adopted similar measures as, even if such instances were not available, our special conditions may call for special measures. A book of this kind should, however, discuss the feasibility, perhaps not the advisability, of such measures, even though they may not be necessary at all. Those who oppose the suggestion contend :—

1. That this would bring about scarcity of money
2. That the money would come back to the foreign banks
3. That securities would fall heavily in prices when the foreign banks unload their holdings
4. That the deposits would be lost to the banking world
5. That the sale of 65 crores of exchange at one time would disorganise the exchange market.

We shall try to see how far these contentions are justified and, if it is found that that they are not, it should be conceded that the prohibition of deposits to foreign banks is a feasible idea, and that the "*case for prohibition*" was lost as the counsel for the plaintiff had not studied his brief properly.

With regard to the first contention it must be said that, if such a scarcity does arise, it would not increase the cost to the borrowers. The exchange banks, as we have seen, obtain their deposits at about 3% but they do not lend at less than an average of 6½%, as will be seen from the following table showing "Bank rate, minimum 6%," while they often lend at one % above Imperial Bank of India rate :—

Table 26—Average interest rate on loans—1926-1930.

Year	IMPERIAL BANK OF INDIA RATE			
	No. of days. 6% or less	No. of days. 7%	No. of days. 8%	Average rate.
1926	.. 365	...	...	6.00
1927	.. 243	122	...	6.33
1928	.. 174	192	...	6.32
1929	.. 176	133	56	6.67
1930	.. 273	92	...	6.25
Average of five years		...	...	6.39

The margin for the banks is thus about  $3\frac{1}{2}\%$ . It is said that the banks lend to shroffs and others at very cheap rates and that, if the funds go to Indian banks, the country would have to pay a higher rate of interest. This does not seem to put the case quite correctly. The deposits of Indian banks are more costly than those of foreign banks, not so much because people distrust them, as because all the better class of depositors have been attracted to the foreign banks. If they are turned towards Indian banks, they would not cost these banks more than  $3\frac{1}{2}\%$  average and, because the margin of lending for Indian banks is less on account of smaller overhead charges, the cost to the borrowers would not be greater than now. It should also be remembered that the Reserve Bank would see to it that the country has cheaper money than now and would prevent too high rates by its open market operations, if it finds that the banks are trying to charge unduly high rates.

As regards the second contention, that the funds would go back to the foreign banks, it must be pointed out that deposits are a form of borrowing and when deposits are prohibited, all forms of borrowing in the country would be prohibited except from the Reserve Bank. Call them deposits, call them loans, the result is the same. If the foreign banks want permanent capital they must bring it from their "HOME", as the non-British banks are now doing for their bills and cash position. But borrowers would not resort to the foreign banks in these circumstances, as they would know that the cost of such borrowed money must be higher than that of Indian funds and that they would be charged far higher rates than would be available from Indian banks.

The alarm that is raised<sup>d</sup> regarding the sales of securities has no real foundation. We have seen that, of the holding of 26 crores of securities of foreign banks, their own money from Indian deposits would not be more than eight crores and most of these are in the form of Treasury Bills; and sales of Treasury Bills would not depress the general securities market. Even if some of the investments were in long term securities, what would be the effect of four or five crores in a market with 450 crores, of which more than fifty crores are being

turned over all the time? The argument loses all force on account of the negligible size of the investment in securities.

The funds so released would not be lost to the banking world. The men who deposit with foreign banks are very careful men, but they are men who deal in foreign trade, who are business-men or who live on the interest earnings. None of them can afford to hoard their money and they must seek some other form of investment. With the rediscount facilities available from the Reserve Bank, part of these funds would go to form the discounting houses and part would be deposited with Indian banks. The discount market, as we have seen, would find scope enough in the foreign bills and in the financing of exports and imports in the port towns.

The fear about the exchange rate breaking down is also unfounded. So long as foreign banks can obtain cheap money in India, they are glad to enter the domestic field. But, when they have to do business with their own money, they would not bring out more than the minimum necessary for exchange banking. They would then require only three week's purchase value of bills or, at an outside estimate, about 20 crores. It is not likely, either, that they could borrow in the London or other markets 65 crores or £50 millions on their own credit for use in India. Twenty crores of sterling exchange is not a difficult thing for the Indian exchange market and in these days of low sterling rates, the Government would be glad to see any foreign money come in and steady the rate.

We have seen in another chapter that a diversion of deposits would be a gradual process and not of the nature of a military order to be carried out at the minute. It will take some years, say five, and this would give time for the foreign banks to bring in their own money at the rate of five crores per annum ; for the discount houses to be started ; for acceptance business to become popular ; for depositors to organise new banks, or to transfer their funds to other banks ; and for borrowers to arrange with other banks for their accommodation. The scheme cannot, in any case, be put into operation before the Reserve Bank is started, because it is so closely associated with the several considerations raised.

It would, therefore, seem that the prohibition is not such a mad scheme as is made out by the Central Banking Enquiry Committee. It may be "impolitic", it may go against vested interests, it may even bring about a new order of things. But the world is ever changing and, as the popular Poet Laureate of England has said :—

The old order changeth yielding place to new,

Lest one good custom should corrupt the world.

## CHAPTER XL.

### AN INDIAN EXCHANGE BANK.

*"Mine honour doth demand it"*

Capital—Special loans—Service of British loans—Preference  
in sterling allotment—Export bills.

The Central Banking Enquiry Committee has recommended the starting of an Indian Exchange Bank under more or less State control, and with special privileges from the State and the Reserve Bank.

The capital of the bank has been variously estimated between two and ten crores. Those who desire a larger capital are thinking of a purely private bank which will have to depend for its status on its capital resources. Those who suggest the lower amount are thinking of a State Exchange Bank, in which case, of course, the capital resources would not count so much as the degree of the State-aid and the guarantees that go with it. Between these two extremes, perhaps, lies the true solution. For purposes of comparison the capital resources of some exchange banks are given below, together with the total exports of the countries concerned, the amounts being given in crores of rupees :—

Name of Bank.	Capital.	Exports.
Bank of Montreal .. ..	9·8	330
Ionian Bank .. ..	0·8	44
Banque Belge pour l'Etranger .. ..	1·5	225
Comptoir National d'Escompte de Paris .. ..	4·3	550
Nederlandsche Handel Maatschappij .. ..	8·9	300
Credito Italiano .. ..	5·1	290
Yokohama Specie Bank .. ..	13·7	275

The State Exchange Bank is considered more desirable because of the volume of the Government operations. If the Government can start an institution to purchase bills on London sufficient to give it the requisite London funds, it is claimed that this is not State competition with the commercial banks. If we remember that, at present, the Government gets its sterling at approximately the intermediate rate, it will be seen that, if it has a special institution to buy in the open market, it might endeavour to buy at the bank's buying rate, but it could even buy at more favourable rates to the public because, even then, the cost of the sterling would be lower than at present. This would mean that the State Exchange Bank, by offering better rates than the banks, would bring about a form of State competition which is objectionable on principle. If, on the other hand, it is a purely private bank, it is feared that it cannot successfully compete with the already established foreign banks who are most of them very powerful and have foreign connections and efficient agents at all important financial centres. The supporters of the State bank idea further hold that, under present conditions, this is the only way to start the bank. In view of the shyness of the Indian capital market and in view of the urgency of the problem, they regard the State bank as the only feasible proposition. There is the possibility, however, that the Government may take its own time to start the bank while, for a semi-private bank, the promoters will see to it that adequate support is given by the Government to the institution.

The combination of State and private bank suggested by the Committee is a good basis to work upon and, for this bank, the capital need not be as high as for a purely private bank and five crores should be enough. This would have some relation to the volume of business it would transact and the standing it will have to acquire. The capital would be augmented by the deposits of clients engaged in foreign trade and special funds. It will require assistance from the Reserve Bank in the form of a loan of ten crores as and when required, at a rate which would be a shade lower than that at which the exchange banks are able to borrow money in India or in

London. Some of the bank's funds will have to be transferred to London both for its own transactions as for carrying on its agency work on behalf of the Reserve Bank. It cannot, of course, borrow in the London market on its own signature, unless the Bank of England makes an exception in favour of it, or of Indian banks in general, on the principle of reciprocity. It cannot afford to borrow from the Bank of England itself as interest will be distinctly higher than bank rate.

The success of the Yokohama Specie Bank, the semi-official exchange bank of Japan, is due not only to the loan of yens 20 millions from the Bank of Japan, but also to its being the custodian of the Bank of Japan's foreign transactions. It helps to issue the foreign loans, to make interest payments on them, and to collect amounts due to the Japanese Government. To that extent it has been a State Bank and the State therefore exercised a good deal of supervision in its management and appointed several of its Directors and also a Governor and a Deputy Governor. A somewhat similar procedure and similar status will seem advisable in the case of the Indian Exchange Bank. Without such privileges its progress may not be anything like satisfactory.

A London branch is an essential part of the scheme. As a semi-State bank, it can try to obtain almost complete access to the London Market in the same way as the Yokohama Specie Bank now has. Nor need it be feared that the Bank of England would refrain from helping it. As agent of the Reserve Bank of India, it should be able to depend on timely assistance from the Bank of England to a degree to which a private bank could not aspire.

At the present time, the sterling loans of the Government of India are being handled by the Bank of England which, apart from the advantages of the Secretary of State's balances, also receives a service charge. If this amount is available to the Indian Exchange Bank, it would raise its status and go a long way to make its London branch a paying one; the advantage to the Government would be that this would minimise the commitments under the guarantee it would make to the shareholders of the bank. It would also create for the

Government a higher position in international circles to have its own bank in London than being, like the smaller nations, a client of the Bank of England.

The Indian Exchange Bank is to have the monopoly of the Government remittances. In this connection, the foreign experts criticised the scheme as unworkable owing to the fact that the Reserve Bank should be the sole authority to determine the time and manner of the remittances and that, if another institution had the management of them, there would result a sort of duel between them in the matter of exchange policy. What is proposed, however, is merely to employ the bank as the agent of the Reserve Bank. The latter would advise it of the amount and the rate it wished to secure. All the foreign currency in the hands of the Indian Exchange Bank, which it could spare, would be sold at this rate, and the balance would be bought from the foreign banks which would have to compete for them as now. The Indian Exchange Bank would not make any charge or profit on the open market purchases and would deliver them to the Reserve Bank at the rate at which they were bought.

The same effect could be achieved by the Reserve Bank keeping full control of the purchases and, after calling for quotations for the amount it wishes to buy, allotting to the Indian Exchange Bank the full amount it has applied for at the highest rate of tender and the balance at that rate to other banks. At the next lower rate, the Indian Exchange Bank would again receive full allotment and the other banks in proportion to their tenders. The total remittances being about £40 millions annually, this would be a valuable privilege in view of the difficulty that Indian banks which entered this field have encountered in disposing of their purchases of bills. Similarly, if the Reserve Bank finds that, for maintaining the external value of the rupee, it should sell some sterling at discretionary rates, it will first make the offer to the Indian Exchange Bank and sell any balance it may have to the other banks.

It may be that the purchases of the Reserve Bank would not be conducted in the open manner of the present tender

system. But this will not mitigate the form of preference it would give to the Indian Exchange Bank. It would settle the rate by negotiation and allot to the bank as much as it is prepared to take up at that rate, and then proceed to distribute the balance among the others.

The Reserve Bank could also arrange with the Indian Exchange Bank that it would hand over to it its bills on London or hold them for its account and forward them on its behalf to London, and the Reserve Bank could advance funds in India on the strength of their security. As these bills will be gold assets, the expansion of currency against them would not affect the gold reserve position ; if necessary, it may be provided that the issue of such currency would be only to the value of the foreign currency acquired.

This would, of course, bring too much sterling into the hands of the Reserve Bank in some months of the year, but it could exercise its option of selling sterling to the banks at a rate higher than the statutory  $1/5\frac{4}{7}$ . The banks handling imports would then have to depend on these sales for sterling cover against their own sales to importers. Of course, when there was a real surplus of supply of exchange, then it is proper that the Reserve Bank should absorb it. There will be one advantage out of this arrangement, from the Reserve Bank's point of view. As the foreign banks will have to resort to it for cover, the Reserve Bank would be able to use this circumstance to maintain control over their other operations.

The Minority of the Central Banking Committee, have pointed out the inadvisability of experimenting with the Imperial Bank of India as the Indian Exchange Bank. The reasons in support of this contention have been explained in earlier chapters.

In view of the close connection with the Reserve Bank, the Indian Exchange Bank can only be started after it has commenced working. But the formation of the Bank and preliminary organisation would take a year and the two schemes should, therefore, go hand in hand. Moreover, it may be necessary to train one or two Indians specially for this purpose and it would therefore also be advisable to consider both schemes at the same time.



## CHAPTER XLI.

### STIMULATING FOREIGN TRADE.

*"If you will not buy, you shall not sell"*

Plans of other countries—Several types of stimulation—Does foreign trade mean exports?—The only solution to the dollar problem.

One of the most tenacious doctrines in what is called the 'mercantile theory of foreign trade' is that every country should do its utmost to export as much as possible and import as little as possible. That this is, in practice, impossible will be seen from the fact that if there were only three countries A, B and C and they insisted on sending out more goods than they imported from each other, the total exports should far exceed the total imports and there would not be any balance of trade. If they should all try to export to a fourth country D, competition for this business must become very keen, particularly as the capacity of the country D must be very limited as regards articles which it can afford to import. If it is a highly civilised country, it would have its own methods of manufacture for the very articles which A, B and C want to send to it. If it is not a civilised country, it will have to pay for these imports by exports and it cannot produce much that would be valuable in civilised countries like A, B and C.

However, the fact remains that all countries are anxious to stimulate the export trade and to curb the import trade as much as possible. This anxiety has been considerably increased owing to the heavy obligations of the war debts in belligerent and even non-belligerent countries. Moreover, the advanced ideas of socialism in modern times have increased Government budgets and this has necessitated resort to direct and indirect taxation which could only be sustained by a high level of production. The programme of stimulating exports was adopted not only by the debtor nations, but it has been accepted as a

primary doctrine even by a creditor nation like the United States which is in the *unenviable* position of having in its custody nearly one half of the total supply of monetary gold.

There are at least eight important methods of stimulating exports. The first is the tariff duty on imports. This tariff duty might be protective for the home producers and might then be about 5-15% but even 100% or more. But it might be a luxury duty, in which case, it might be as much as 200% or 300%. The idea is to make imports costly owing to the imposition of such duties and, by the raising of internal prices, discourage their consumption.

The second method is the granting of bounties to producers. The aim of such bounties is to enable producers to compete in international markets. It means that every person who exports these articles is entitled to be paid a bounty of a certain percentage of the value of the exported articles. In other words, exports are stimulated by being sold at a lower price outside the country than inside. Instances of such bounties are the Java and Mauritius sugar, Brazilian coffee, and German beet sugar.

The third is the plan adopted by Germany. In the last years of the 19th century, she launched out on a policy of selling and, apart from bounties and other methods, she helped her foreign buyers by extending better terms of credit than British and other producers.\* This was certainly risky, but it was a valuable advertisement and made it possible later on to organise the credit facilities on sounder principles. The popularity of German goods has been promoted further by postwar reconstruction which has made it necessary for other nations to buy her goods in order that she may pay the reparations demanded of her.

The fourth method is to provide funds for the export trade at a cheaper rate than for other purposes. The chief example of this is Japan whose "stamped bill" system has already been described in detail. Under this system export bills were financed at 3 to 4% while other bills were charged 7 to 8%.†

\* P. Barrett Whale—Joint Stock Banking in Germany.

† J. Inouye, Problems of the Japanese Exchange, 1914-26.

The fifth method is that adopted by Japan in the starting of the Yokohama Specie Bank by Count Okuma in 1880 with a capital of six million yens, partly subscribed by the Government in the first instance. It was reorganised in 1882 by Prince Matsukata and "for nearly 30 years the Yokohama Specie Bank remained the only exchange bank of importance in Japan with the exception of the foreign banks, and the greater part of the country's trade is still financed through it. During its entire history official supervision over it has been strict and the Government has thus been able to regulate to some extent the direction and nature of the country's foreign trade. With the growth of Japan's commerce the bank naturally increased in size. Its capital which was six million yens in 1887, and twelve million yens in 1896, has grown to 100 million yens at the present time and its loans and holdings of bills have increased in a like proportion."\* The Yokohama Specie Bank has a permanent loan of twenty million yens at 2 per cent besides getting special loans occasionally from the Bank of Japan. Its present capital and reserves amount to 215 million yens and its total liabilities 1,136 million yens. Similarly, France has created the French National Bank for Foreign Trade.

The sixth method is the co-operative system of the United States. The promotion of foreign trade in that country attracted so much attention that special legislation was passed to protect exporters from the operations of the anti-trust law which was designed to fight the monopolistic tendency of the mass production systems of manufacturers. "The specific reasons why the lifting of the anti-trust ban should prove beneficial in the promotion of American export trade were revealed in a survey conducted by the Federal Trade Commission. The report declares that, 'while the United States has been absorbed in domestic development, other nations have followed definite policies for the expansion of their foreign trade and have perfected efficient means for the purpose in view' and that, 'in seeking business abroad, American manufacturers and producers must meet aggressive competition from powerful

\* G. C. Allen, *Modern Japan and its problems*, page 161.

foreign combinations, often international in character.' In conclusion the Commission finds

(1) That other nations have marked advantages in foreign trade from superior facilities and more effective organisations,

(2) That doubt and fear as to legal restrictions prevent Americans from developing equally effective organisations for overseas business and that the foreign trade of American manufacturers and producers, particularly the smaller concerns, suffers in consequence."\*

Consequent upon the removal of the ban by the Webb-Pomercene Act, American co-operative sales organisations for foreign trade have grown up and they have succeeded in capturing several markets which were formerly closed to them. These organisations have received the active encouragement and support of the American commercial banks, the Federal Reserve Banks and the Government. The United States also encouraged foreign trade by the Edge Law permitting National Banks to participate in the formation of foreign exchange banks and by a special amendment to the Federal Reserve Act permitting the Reserve Banks to rediscount bills drawn for the purpose of financing foreign trade.

The seventh method of promoting foreign trade is by lending money to nations who cannot buy. We shall study elsewhere the effect of such loans on the lenders and the borrowers. The point in this connection is that the lenders usually make it a condition that the borrowers shall use a good portion, if not all, of the money in buying goods from the lenders. Examples of such credits are the British Trade Facilities Act, the German system of making loans for railways and other development in neighbour countries and the Belgian credit for railways in Argentina. The British Trade Facilities Act provides for the Treasury to underwrite certain loan issues to help them to be floated at a low rate of interest but this provision is subject to an undertaking by the borrower that the funds will be spent in Great Britain. The lending country obtains a specific assignment of some assets of the borrowing country as security for

\*G. G. Huebner and R. L. Kramer, *Foreign Trade*, pages 333-334.

*the loan and, in some cases, has even obtained the valuable concession of controlling railways, oil-fields or mining areas.*

The eighth method is the system of credit insurance by private or State agencies, chiefly, on behalf of exporters. This is dealt with in the next chapter.

It will be seen that, in all these cases, foreign trade is supposed to mean 'exports.' No one seems to have thought that it is not so easy an affair. You may try to sell your goods but you must buy something, at least, you must do something with the money to make it valuable to you. You may accumulate foreign balances by selling the exports but what can you do with them? You must buy goods in that country or transfer them to some other country and buy goods from *that* country. You may repay your loans abroad and, if you have no loans, you may try to lend the money to others. But there is a limit to this lending. It might either be lent to doubtful borrowers or to people who, with the best will in the world, cannot even pay the interest on the loans out of their current income. This process of over-lending is well brought out in the case of the United States whose total investment abroad amounted to about 9,000 million dollars in 1920 and to 16,600 million dollars at the end of 1929 and has been steadily mounting up at the rate of 1,600 million dollars every year and should now stand at about 20,000 million dollars. The loans to other Governments alone were as below, in 1931 January :—

Table 26—European War Debts in 1931.

European debts to America.				Other countries to England.			
in millions of £				in millions of £			
Britain	..	..	£880	France	..	..	£771
France	..	..	770	Italy	..	..	258
Italy	..	..	400	Dominions	..	..	116
Belgium	..	..	80	Jugoslavia	..	..	32
Poland	..	..	40	Roumania	..	..	30
£2,170				£1,207			

The annual interest return is about \$1,000 million, which has to be invested or lent abroad, thus decreasing the capacity of the debtors to repay their obligations. This has resulted

in the recent impasse which made it necessary for America to suspend a year's payment of interest from foreigners, as announced by President Hoover. And yet, America will not lower her tariff wall, nor will she allow others to repay their obligations, and she has always had a credit balance of trade on merchandise, the results of 1930 being \$660 millions.\* The export of gold to America is limited by the size of the annual output being only about \$400 million and is out of the question, though most of it does go to America even now, under difficult conditions. But there is such a thing as killing the goose that laid the golden eggs and America may one day find herself confronted with the problem of disbanding her vast army of workers or relinquishing all rights to repayment of foreign loans. She may perhaps see much wisdom in the dictum of Charles Lamb's friend that "money kept more than three days stinks."†

England, on the other hand, has pursued a policy of permitting others to send her goods and the adverse balance of merchandise trade is usually about £400 millions which she makes up by her merchant shipping service and by interest payments due and other services. But even she finds that it is becoming more and more necessary to re-invest abroad and even to make new loans, and the volume of new floatations amount to £120 millions per annum.

The total world trade is about £6,000 million and every country, therefore, seems anxious to obtain as much as possible of this trade for itself, but does not see that there is a limit to this form of activity. As Mr. Spalding very aptly puts the situation in his "Finance of Foreign Trade,"

"We hear a lot, a terrible lot about our export trade, but politicians and the man in the street, whom the old sage of Chelsea described as "mostly fools", seem to forget that our export trade involves also an import trade. The nation that will not buy, neither shall it sell! This is a short and sweet phrase which might be repeated to those good folk who so constantly urge that we must keep and expand our export trade while, at the same time, curb and limit our import trade. These people add that while we are doing all this, we must make the fullest possible use of our mercantile marine; we must render more and more shipping

\* Monthly Bulletin of Statistics of the League of Nations.

† Such a suggestion is now being made in responsible quarters in New York.

services to other nations—hold the rest of the world in fee, in fact. Further, it is said, we must be so careful, ever so careful, that they do not render more than the barest shipping services to us. None of these people ever tell us in what conceivable way we are to be paid for the additional shipping services we are to render, or for the heavily expanded exports we are to ship to other countries.”

It is not the province of this book to discuss the ethics of foreign trade so much as to discuss its economic reactions. Still, it is permissible to point out that a nation which has an empire from which it receives tributes, be that empire a political one as in the case of England, or an economic one as in the case of the United States, must abide by the consequences of its domination. It must come to the same conclusion finally, that the foreign trade must become more and more confined to imports as the volume of invisible export grows. There would then, result a steady growth of perennial unemployment, unless it returns to a more sensible system of rationalising its production by employing more men than machinery. Or, it could, as suggested in the case of the United States, remit some part or the whole of the debts due and start writing again on a clean slate, thus preserving the vigour and enterprise of the older generations which have built up the empire.

The expansion of export trade is only permissible in the case of the debtor nations who *must* sell in order to pay the interest and other obligations. To them, the policy recommended by the wise men of the mercantilist persuasion would truly apply, to curb or abolish imports and stimulate exports. The more the volume of excess exports, the sooner can they repay their indebtedness and bring the world back to the state of economic efficiency where each country has to labour to create the necessities of life for its people. As Mr. F. Mlynarski says,\* “The mercantilism of new and economically weak countries should not be viewed in the same way as the mercantilism practised by old and strong countries. For the protectionist policy of the new States was, and is, rather the *result* than the *cause* of the postwar difficulties.” There would thus be nothing wrong in an Indian Government pursuing a

\* Gold and Central Banks, p. 100.

policy of protection, bounty, State-aid, stimulation of exports and all the other methods of creating that surplus of exports which the country requires to pay its foreign obligations. To us the maxim would be :—

*“The country that cannot sell, neither shall it buy.”*

## CHAPTER XLII.

### CREDIT INSURANCE SCHEMES.

*“To help the lame, the timid and the weary”*

Credit insurance—By private agencies—By State agencies—  
The British scheme—A scheme for India.

The stimulation of exports by credit insurance has been adopted in several countries, but little attention has been paid to the needs of the importers who also have a right to live, “go forth and multiply.” The simplest form of the credit insurance is for private agencies, or State agencies as in Britain, to insure the exporters or the banks against the risk of losses due to failure of foreign importers between the time of shipment and the realisation of proceeds. Logically, it could extend to the importers also for, when a foreign exporter has asked for a credit to be opened in his favour, it is a matter of some risk for the importer to open it, as he might receive goods not of the correct description and, though attempts could be made to obtain legal redress, the compensation may not be satisfactory.

The German companies originated in the prewar efforts of that country to capture the markets of the world. They were, in fact, the first in the field and by the beginning of this century they had created some efficient institutions in this line, the chief ones being the “GLOBUS” and the “HANSEATISCHE.” They were considerably helped in their operations by the Government which considered the extension of foreign markets of such great importance as to go out of its way in several directions to help its promotion.

In Great Britain, private business was started by the Securities Insurance Company, Ltd. but, before the scheme could be judged properly, some of the trust companies took it



up and came to grief. The data on which they worked were very inadequate and the risks assumed too serious. The Trade Indemnity Corporation was a postwar development and is now the only private company doing credit insurance business, but its work is confined only to countries deemed quite "safe."

In the United States, the insurance companies which have undertaken this business have evolved a graded system of risks in accordance with credit reports about individual foreign importers, the standing of the exporters and the type of commodity moving. The premium charged is the value of the goods multiplied by a fraction representing these risk items. The system would seem to have justified itself as it has been in operation through the strenuous period of postwar reconstruction and can be considered to have passed through normal, and even abnormal, trade depressions and catastrophes.

In China, the insurance is done through the medium of the compradors who are sureties not only for their clients but also for any losses arising out of bills purchased from them. So essential is the comprador that no bank would take a bill direct from other parties. The compradors are paid a commission which is something more than brokerage because, in addition to the guarantee for the performance of the contract as in India, they guarantee the reliability and integrity of their clients. The guarantee of the exchange broker does not extend to the trade risk arising *after* the performance of the contracts he puts through, but the comprador is responsible for losses up to the liquidation of the bills. The comprador acts also as a fidelity insurer of Chinese employees in the banks. In earlier days, his word was security enough, for the banks but, after the war, the spirit of distrust has spread widely and compradors are now required to pledge adequate securities in cash bonds and title deeds to property.\*

The comprador system is also prevalent in the Straits Settlements and the banks depend so much on them that business is done mostly through them. In the earlier days, business in India was also done through the Banyans or Dubashes, but the

\* G. G. Huebner and R. L. Kramer, *Foreign Trade*.

banks have gradually worked up their own credit service and the cashier in several banks now corresponds to the Banya, but his responsibility is merely in obtaining information about clients for which he does not hold himself out as liable.

The first country to adopt a governmental system of insurance was Sweden which appointed a Financial Council to work with the banks and other concerns which were giving credit to foreign clients. The idea was chiefly to facilitate movements of goods to the Baltic and Central European States.

- The Belgian Government's plan was intended to relieve unemployment which had risen very high in 1920. Under this plan, a big Belgian firm was helped to export railway rolling stock to Argentina. Another textile firm was helped to export yarn to Roumania. This is thus essentially different from other forms of insurance which are intended to help all classes of exporters who could not get credit, in many cases because their needs were too small. The Belgian scheme was intended rather to help those who could not get credit because their needs were too big, and is now almost in disuse.

In France, the work is carried out by the French National Bank for Foreign Trade\* which was started after the war. The management is in the hands of a body consisting of two-thirds commercial men and one-third bankers but the Government has been prepared to pay the cost of running the bank until it becomes a paying concern, and has also given it a substantial loan without interest. The chief business of the bank is to accept ninety days bills for exporters on the security of the export bills which are taken over by the bank for collection. The accepted bills are then discounted in the Paris market and may be renewed if necessary. The bank also collects information regarding the credit of foreign exporters and importers and acts as agent for French exporters in cases of trouble in foreign countries. It has also several other functions of a subsidiary character.

The movement started in England in 1919 in the operations

\* League of Nations Bulletin, Relief Credits and Promotion of Exports.

of the "War Risk Insurance Office." Later, in 1920, the Overseas Trade (Credit and Insurance) Act was passed, under which £26 millions were granted to the Department of Overseas Trade to make advances to exporters of goods to the Balkans, Baltic and Central European countries. But exporters did not take much advantage of the scheme ; and yet the Government suffered heavy losses for several reasons and, in 1921, it was changed to a scheme of credit insurance, whereby the Department agreed to guarantee the negotiating banks in regard to bills of parties with whom it had entered into a contract for the purpose. This scheme was not much more successful and it was overhauled in 1925 and further amended in 1929. It now extends to all countries and for all commodities except textiles, for which latter, it is limited to all territories except the Eastern countries.

The business is entrusted to a department of the Board of Trade. When an exporter wants to benefit by the scheme, he makes an application in which he affirms that the goods are of British origin or manufacture. When the bills are ready, the department signifies the guarantee, either on the face of the bills, or in a separate certificate, and it receives suitable security from the exporter and also the premium. The bills are then discounted by the banks and if there is any loss on the transaction, the premium fund and the exporter share it on a previously agreed basis. The scheme in this form has not been in operation sufficiently long to judge of its success but, as the "Big Five" have agreed to the main details, it would seem that it is sound.

While most of these schemes have been started for special reasons and in times of depression or unemployment, the general idea behind them is getting to be more and more understood and it is possible that they will form part of the regular scheme of foreign export finance in the future. When the States will see that the importer is also a useful creature, they would include him also in the scheme of things.

Some of the complaints before the Central Banking Enquiry

Committee related to a reluctance on the part of the banks to purchase bills of Indian clients, to which the banks have replied that the standing of Indian clients is not easy to ascertain and they try to do the best under the circumstances. Similarly, it was brought out that importers do not usually get credits opened for their account, the reason being that they were usually men of small means and that the banks would not run the risk. It was also understood that even when credits are opened, they are revocable and bills are drawn on the clients and not on the banks as in other countries. If there were in operation here a scheme of insurance to protect the banks against such possible losses, the purchase of export bills should become more common, and it would also be possible for the exchange banks to open credits for importers more readily, to make them irrevocable and to have the bills drawn on the banks themselves, which would be of great value when the discount market is established in India.

The following plan for a Foreign Credit Insurance Scheme is based on the British model with variations to suit Indian conditions. As the Board in charge of it will be a governmental institution, its benefits will be available only to Indian traders, particularly as no complaints were made before the Central Banking Enquiry Committee of inadequacy of facilities by European traders. The Foreign Trade Board would naturally be a provincial organisation, but there would be no particular harm in its being an all-India organisation, if desired. It should be first started in Bombay and Calcutta and, if found successful, other Boards may be started in Madras, Karachi, Rangoon and other centres.

The capital of the Board will be furnished by the Provincial Government concerned and should be sufficient to inspire the confidence of the banks, though it will not be required in actual practice, if the premiums charged are adopted from the experience of other countries. In the first few years, the business may not be in sufficient volume to make it possible to meet expenses and, during that time, it may be necessary for the Governments to assume the cost of maintaining the Board.

## FOREIGN CREDIT INSURANCE SCHEME.

1. The Foreign Credit Insurance Scheme in any province will be in charge of a Board consisting of some local bankers and business-men in active trade.
2. In the case of exporters, it would enable them to sell their bills and, in the case of importers, it would enable them to have credits opened for their account in favour of exporters abroad.
3. For exporters, the Board will guarantee the banks against any losses which may arise out of their buying bills from such of them as have entered into a contract for that purpose with the Board.
4. In the case of importers, it will insure the banks against losses due to opening credits for clients who have made insurance arrangements with the Board. It would also insure the banks against losses due to delivering goods under Trust Receipts.
5. The facilities of the Board will be available only to Indian exporters and importers.
6. The application for such facilities should be made through the bank with which the client usually carries on business.
7. The premium to be charged will depend on the class of commodities and on the percentage of the risk to be assumed by the Board. If a lower percentage is to be taken up by the Board, the premium shall be correspondingly lower.
8. The Board will undertake to indemnify the bank in full but the Board's share will, in no case, exceed 80% of the loss incurred.
9. Before the risk is actually undertaken by the bank, it will submit to the Board the documents or the Credit application form which the Board will endorse or on which it will put a notation that a certificate has been issued in this respect.
10. The bank must guarantee that it or its agent will present the documents to the foreign importers and, in the case of imports, that the documents of the foreign exporter will be properly scrutinised. If there is any loss due to negligence on the part of the bank or its agent, the bank must promise to reduce its claim by such amount.
11. If the insurance on outward shipments is undertaken by the foreign importers the Board shall have full recourse against the Indian exporters until the bills are accepted.
12. The importer or the exporter and the bank in India should help the Board in every way in minimising the loss if the transactions are not duly completed. The Board will have a prior claim to the proceeds of the goods or bills and, if the amounts are in the hands of the bank, the claim should be reduced by those amounts before application is made to the Board.
13. The exporter or importer shall pay his share of the loss as soon as it is definitely ascertained, including all bank charges and any prior claims on the relative goods.
14. Neither the exporter nor the bank shall extend the term of the bills without the previous approval of the Board.

15. The guarantee shall usually be for a period of six months after the transaction is entered into, or for a total period of nine months after application has been approved by the Board.
16. The exporter or importer shall deposit with the Board such security as may be satisfactory to it, for the due performance of his share of the transaction. Such security may be in the form of cash, negotiable securities or title deeds relating to property or a bank's guarantee.
17. If the exporter or importer will give the Board the right of full recourse against him, the premium may be reduced accordingly.
18. The facilities may be availed of as one transaction or in several transactions extending over the period for which the guarantee of the Board will be operative. In the case of goods in the process of manufacture or production, the Board may, at its discretion, extend the period to one year, if it is satisfied that the extension is necessary.

## CHAPTER XLIII.

### THE TWO RACES OF MEN.

*"I bought for cash, I bought for credit"*

The two races of men—Effect on exchange—Future burden on the exchange—The Reparations—Loan programmes—The case of Australia—The case of India.

Charles Lamb in his 'two races of men' divides them into the race of borrowers and the race of lenders. The borrower, according to him, is an optimist, while the lender is a pessimist. The cheerful countenance, the self-confidence and the hopefulness of the borrower contrast very strongly with the woeful face, the trepidation and gloom of the lender. It is said that a man's best well-wisher is his insurance company, but, perhaps, his really best well-wisher is his creditor, because he prays not only for his long life but also for his continued prosperity. The borrower does not worry himself so much about how he will return the money as about how he will get it, and the lender does not worry himself so much about how to lend as about how he will get the money back. When, therefore, a nation borrows from another, there are two aspects that are very important ; whether it takes the loan in too cheerful a spirit and whether it has the capacity to repay.

The effect of loans on exchange differs with the purpose for which it is raised. If the idea is to buy goods from the lending country, then the effect of the loan is to postpone the payment for these goods to a later date and thus avoid the violent fluctuation of the exchanges which would have resulted in remitting the money from the borrower's country to the other. In this case, the interest on the loan and the annual repayments would constitute an instalment payment for the goods purchased. In order to pay these instalments, however, the borrowing country must export commodities and the exchange created by these commodities would be utilised to extinguish the debt. In effect, therefore, a foreign loan spent in that country is the equivalent of supplying goods on credit to be repaid in instalments by the borrower's products.

The money may be spent in a third country and in this case, the transfer of funds to the third country must result in a temporary weakening of the lending country's currency in terms of that of the third country. The repayment of the loan is, however, to be made by instalments as before, and this has to be done by exportable goods and will affect favourably the exchange rate of the lending country on the borrowing one.

It may be that the borrowing is made in order to utilise the funds in the borrowing country for local purposes. In this case the transfer of funds from the lending country will create a demand for the currency of the borrowing country and there is an artificial strength given to that currency as against that of the lending country. This strength may prove to be undesirable in the sense that the artificial strength will disappear immediately the transfer of funds is completed. The country, therefore, would have obtained a smaller amount of local currency than it would have received if the exchange rate had not been so strengthened. When it starts to repay the loan, it would find that the demand for foreign currency thus created would weaken the local currency, with the result that it will receive a smaller amount of foreign currency than it would otherwise do. Consequently, the floating of a foreign loan for domestic purposes twice affects the borrower adversely.

Thus, if the Indian Government had issued a loan of £6

millions in 1913, it would have realised 9 crores and, at the present rate of exchange, it will be necessary only to repay 8 crores. This is, however, unreal if Indian prices have been adjusted to the higher exchange rate, but will be real to the extent to which such adjustment has not taken place. If, for some reason, the rate of exchange is now changed to 17d. or 16d., then the burden of a loan of 1928 for £6 million, for which we realised 8 crores of rupees, will become  $8\frac{1}{2}$  or 9 crores when we have to repay, while the local value of the commodities would not have adjusted themselves to the lower exchange rate.

In all the three cases, the borrowing means a future burden on the exchange rate and the country must be in a position to make up for this weakening by a sufficient excess of exports over imports. The effect on exchange of loan operations may be looked at in another way. When the loan is issued, the borrowing country practically exports the bonds against which the loan is subscribed. In the same way, having interest to receive on the loan, the lending country exports the interest and dividend coupons which have to be paid for. When repayment of the loan is made, it is as if the lending country exported some of the bonds in its hands.

We have seen that whenever borrowed money is spent abroad, the exchange value of the lender's currency in terms of some other currency depreciates. Partly to counteract this, but equally, perhaps, through the desire to take advantage of the occasion to foster the foreign trade of the country, the lender usually insists that the money shall be spent within its own borders. In cases where money is to be spent in the borrower's country, the lender often tries to obtain some concessions, both in order to increase its foreign connection and also to obtain some sort of control over the assets created by the money borrowed. In cases where the money is spent in a third country, the lending country often insists on the assignment of some specific assets of the borrower as security.

There is a new type of debt that has been in vogue in modern times. When the nations war with each other, the vanquished nation is made to pay an indemnity to the con-



queror, be it the aggressor or the "aggressee". When Japan vanquished China, there was created a war indemnity which was to be repaid in the course of a few years but which served as a drag on the progress of China. After the Boxer Rebellion in China the foreign nations insisted on an indemnity which has been paid now for several years and will have to be continued for some more time, unless a sense of the injustice of the idea dawns on the others. When Germany conquered France in 1871, she insisted on heavy indemnity payments ; and nemesis came back in 1918 when France sat at the same table in Versailles and dictated the amount of the indemnity to be paid to her. The amount was certainly vindictively high and has been revised several times both as regards the total and as regards the method of repayment, and the final form which it took was that there would be conditional payments and unconditional payments.

The essence of the Reparations problem is that, Germany having no other means of paying the indemnity, has to export goods and, as several writers have pointed out, the 'question is not merely that of Germany's capacity to produce the goods, but that of the other nations to receive them'.\* It means, in effect, that the industrial activity of the conquerors is bound to suffer in order that they may buy German goods. The history of the Reparations payment is, therefore, a perpetual conflict between the conquerors' desire to receive money and their desire to flourish.

It is permissible to point out in this connection that, even allowing the justice of the biblical saying that the 'sins of the father shall be visited upon the children', it seems improper to visit the sins of the grand-father on the grand-children. If a generation has committed an excess of transgressions beyond the limits of forgivable violence, and has made 'scraps of paper' out of treaties and obligations, it is possible to understand the revenge taking the form of punishment of that generation and, perhaps, even the rising generation. But to extend the reparation payments for over 50 or 60 years right

\* F. Mlynarski, *Gold and Central Banks*, page 105.

down perhaps to the third and unborn generations, does not seem so very proper.

To return to the loans and the exchanges, the borrowing country can honestly become a greater race as Lamb calls it, only if it has the capacity to repay the loans, the will to repay them and the desire to repay. If the purpose of the loan is to balance a budget deficit, naturally, there is no possibility of the loan being repaid unless the budget deficit was extraordinary. If the loan was contracted for the purpose of financing uneconomic schemes of development, the result must be the same. If the loans are spent abroad for purchasing materials for development of the country's mineral and other resources, or building railways and other means of communication, the result might be increased industrial and other activity with a surplus of production which can be exported to repay the loan. But it may happen that the schemes might be as enchanting and irresistably tempting as the great Back Bay Scheme of Bombay.

Australia is a very instructive example of a country which has perhaps been ruined by too easy accommodation from creditors. The total interest payments on its borrowings amount to no less than £30 millions and the trade depression of the last three years has hit Australia very badly, particularly, the heavy fall in the price of wool and wheat. The result is that the invisible imports in the form of interest and repayments are constant in terms of gold, but the total value of the exports has fallen in terms of gold and, though the total value of imports of merchandise has also fallen, the difference between the two has likewise fallen; and exports which previously were able to create enough foreign funds for payment of interest on the loans are now insufficient for the purpose.

"Australia has raised extensive loans abroad, principally in London, the service of which is estimated to cost her in the neighbourhood of £30 millions annually. This constitutes, of course, an invisible import which also sways the exchanges against her. In order to maintain her credit in this country, the Australian banks have agreed to make these huge interest and sinking fund payments a first charge upon their cash

resources in London. Early in 1930 the banks were forced to ration the amount of exchange available for their customers in the United Kingdom while the Commonwealth Bank of Australia announced that, for the time being, they would not cash Australian notes outside the Commonwealth.\*

When a country like Australia borrows £130 millions in 10 years and has nothing to show for it so far as the lending country can see, its credit abroad is damaged and its currency must rapidly depreciate, the moment it finds itself unable to meet its obligations to any extent. Consequently, the Australian exchange which was usually quoted at a discount of  $\frac{1}{2}\%$ , that is, Australian £100½ to £100, depreciated in 1930 to nearly 108. The Australian banks then combined and decided to support exchange at that rate. But trade conditions were against them, and the party in power did not take proper steps to balance the budget, with the result that private selling and buying of exchange began to grow to such an extent that exchange business practically passed out of the hands of the banks, who had in the end to surrender unconditionally and remove the control of the exchanges. The rate rapidly declined and, in the absence of any sustained effort on the part of the Government to reorganise its finances, it declined in 1931 June to Australian £130 to £100. It is a problem whether the Australian pound will have to be stabilised at this level, or heroic efforts will have to be initiated to bring it back to parity with London.

Foreign money may also be borrowed on private account by floating shares and debentures of commercial concerns, or by foreign concerns bringing in their own money and establishing themselves in other countries. India is an instance of the latter kind ; Germany, Switzerland, Austria, Czechoslovakia, are instances of the former. The former method has much to be said in its favour, because the borrowing nation retains control over the industries for which the loans are raised. In the latter case, the industries pass over into the hands of foreigners and create vested interests which become a problem not only of economic, but also of political and even international importance.

\* R. H. King, "Principles of Banking, Currency and Foreign Exchange," page 154.

The extent of such foreign investment in India is difficult to estimate. The External Capital Committee of 1924 concerned itself with the theory and propriety of such undertakings but did not enquire into the amount of the foreign investment in India. The Government Report on Joint Stock Companies operating in India shows the capital of foreign companies as about £750 millions. But this includes the capital of the exchange banks and other institutions which have not brought any of their own money into the country. It includes also the big firms like the Sassoons, Ralli Bros. and other concerns which have a good part of their capital employed abroad. On the other hand, it does not show separately foreign investment in concerns with rupee capital nor the tea gardens and other plantations owned by Europeans. A rough estimate would be Rs. 600 crores, which means a minimum interest or dividend earning capacity of 30 crores. As most of this amount goes abroad, it becomes a heavy form of invisible import for India, for which she has to provide by exporting commodities.

We have already looked at the question from the point of view of the lesser race, that is, the lenders. After going through the whole argument it would seem as if Charles Lamb was right when he said that the greater race of men are the borrowers.

## CHAPTER XLIV.

### PURCHASING POWER PARITY.

*"The more you have, the less you have"*

Price levels and exchanges—Purchasing power parity—Defects of theory—Some figures compared—Over-valuation—Under-valuation—The case of India.

The quantity theory of money states that an increase or decrease in the volume of money circulating in a country will increase or decrease prices, so long as other factors are constant. This is modified by the condition that the amount of money should be taken, not as the volume of currency, but as the

product of the volume of currency and the velocity with which it circulates. Thus, if  $C$  is the amount of currency,  $V$  is the frequency with which it changes hands,  $P$  is the price, and  $G$  the amount of goods dealt in, then,

$$C \times V = P \times G.$$

In view, however, of the fact that, in most civilised countries, payments are made more and more by means of cheques, this formula has been altered as

$$C \times V + C' \times V' = P \times G.$$

where  $C'$  is the total of bank deposits and  $V'$  is the velocity with which they circulate. This again, is subject to the limitation that, if any part of the deposits or currency is put to other use than the purchase and sale of goods, then there will be, to that extent, little or no effect on commodity prices. Thus, in the Stock Exchange boom of 1928-29 in New York, there was created a large volume of credit and the bank deposits increased very rapidly but, so far as commodity prices were concerned, there was a heavy decline, as the new money was not utilised for movement of commodities but only for speculative purposes.

When, for some reason or other, there is inflation or an increase in the volume of money in circulation in any country, there will be, in ordinary circumstances, a tendency for prices to rise. One of the results of such a rise in prices is an increase in imports and a corresponding fall in exports. The increase is caused by the fact that importers are able to obtain better profits owing to the higher prices they can get for imported goods in the country. In the same way, exporters are discouraged in competition with others owing to the high price which they have to charge for their goods. This results in a demand for exchange far exceeding the supply and importers are then forced to pay more for the foreign currency than they used to. The rate, therefore, moves against the country. The inflation may be quantitative as when the volume of currency changes or qualitative as when the velocity of circulation changes. In the same way, if there is deflation or the volume of money is contracted, either quantitatively or qualitatively, the level of prices tends to fall, with the result that exporters

are able to compete more successfully with other producers and importers are discouraged by the low prices and consequent low profits. The supply of exchange exceeds demand and exporters receive a smaller price for the foreign currency which they have to sell. Deflation thus creates a rise in the international value of the local currency.

These changes take some time, but the forces creating inflation or deflation may be such that the process cannot be stopped. In the case of deflation, there is usually a limit, due to the fact that a certain minimum volume of currency is essential for internal trade purposes and undue scarcity of money would stifle industry, trade and commerce. But in the case of inflation, which is usually due to the improvidence of the Governments, there is only one limit, and that is the breakdown in the monetary system and international trade with that country, forcing the Government to reorganise its methods. As an illustration the following figures relating to Austria between 1920 and 1922 will be of interest:—

*Table 28—Note issue and exchange value of  
Austrian crowns 1919-22.*

Date		Value of one million crowns.	Note issue in million crowns.
Sept. 1919	.. ..	\$24,000	9,383
Sept. 1920	.. ..	\$ 4,167	31,000
Sept. 1921	.. ..	\$ 908	174,000
Decr. 1922	.. ..	\$ 14	4,080,000

The League of Nations had then to step in to start with a new currency system on the basis of the gold standard. We have seen that the German mark broke down several times, similarly, and marks were followed by Renten-marks and Boden-marks, each in turn to disappear.

The latest theory regarding foreign exchange is based on what is known as the PURCHASING POWER PARITY, enunciated by Prof. Gustav Cassel of Sweden. Its chief postulate is that the important aspect of a movement in exchange rates is not the actual movement itself so much as the cause of that movement. Therefore, it looks not so much

at the trade nor at the temporary inflow or outflow of funds from other countries, but as what is believed to be the cause of all these movements, namely, the difference between the value of money in the two countries, in terms of the quantity of goods it can purchase. Thus, when the rupee is equal to 18 pence and can purchase a quantity,  $q$ , of goods in India and 18 pence can purchase a slightly higher quantity,  $q'$  of goods in England, it follows that the rupee is not worth 18 pence, and is overvalued. In the same way, if  $q'$  is less than  $q$ , it follows that the rupee is worth more than 18 pence, and is under-valued. A person in India can, in the first case, buy goods in England and receive what is called a "consumer's surplus" and a person in England can, similarly, obtain a "consumer's surplus" by buying his goods in India in the second case. By the variation in the volume of exports and imports thus created, a new value of the rupee in terms of sterling will then be brought about.

The relation becomes more complicated when it is desired to compare two sets of rates. If India and England had a certain level of prices  $p_1$  and  $p_2$  and the rate of exchange was 18 pence and the prices changed to  $p_3$  and  $p_4$  respectively, the new prices are  $p_3/p_1$  in India and  $p_4/p_2$  in England of the old ones. These ratios are expressed in percentages and are called the index numbers at that time in relation to the earlier year, referred to as the basic year. To make things simpler, if the index number is  $n_1$ , it means that  $n_1$  rupees have now to be paid for the same amount of commodities instead of 100 rupees previously. The rupee, therefore, purchases  $100/n_1$  times the volume of goods it did in the basic year. Similarly, the purchasing power of the pound sterling is  $100/n_2$  of the power for the basic year. Therefore, the rupee is now worth  $100/n_1$  times the old one or  $18 \times 100/n_1$  pence of the basic year and, as the pound is now worth  $100/n_2$  of the old pound, the rupee is now worth  $\frac{18 \times 100 \times n_2}{n_1 \times 100}$  or  $18 \times n_2/n_1$  pence. If the actual exchange rate today is also similarly expressed as a percentage of the basic rate of 18 pence, then the index number of the exchange, say,  $e$ , should be equal to  $n_2/n_1$ . If  $n_2$  is

greater than  $n_1$ , then  $e$  should be correspondingly greater than 100 and if  $n_2$  is less than  $n_1$ , then  $e$  should be proportionately lower than 100.

If the exchange ratio is higher than  $n_2/n_1$ , that is,  $\frac{e}{100}$  is greater than  $n_2/n_1$ , then the rupee is overvalued and the exchange rate must go lower so that the purchasing power of the rupee may be the same in both countries. If the actual ratio is lower than  $n_2/n_1$ , then the rupee is undervalued and the exchange rate must go higher so that the purchasing power of money may be the same in both countries. These movements may be expressed mathematically in the following form :—

If  $N_1$  is the index number,  $E_1$  is the exchange ratio in foreign currency,  $I_1$  the note issue and these change after a period to  $N_2$ ,  $E_2$  and  $I_2$ , and the corresponding index numbers and note issue in the other country are  $N_3$  and  $I_3$ , and they change to  $N_4$  and  $I_4$ , then

$$\frac{E_1}{E_2} = \frac{N_2 \times N_3}{N_1 \times N_4} = \frac{I_2 \times I_3}{I_1 \times I_4}$$

This relation expresses the working of the dollar standard of today. If the United States increase currency, other countries must do the same thing in order to maintain the ratio and keep relative prices unaltered. That is, if  $I_2/I_1 = I_4/I_3$ , then  $E_1/E_2 = 1$  or  $E_1 = E_2$  and the exchange rate remains unaltered. If this is not the case, the local currency will become over-valued or under-valued. These ratios may be called the exchange rate ratio  $E_2/E_1$ , the index number ratio  $N_2/N_1$  and the note issue ratio  $I_2/I_1$ .\*

This is, of course, only a long period tendency and is not absolute certainty, for several reasons. Between a cause and an effect there is a difference of time known as the time-lag. As the external value of the currency unit can only change *after* there has been a variation in the volume of exports and imports and the variation has become known to the general public, this will take some time to become effective. In the meantime, other causes might be operating in the opposite

\* The highly mathematical can see that  $\frac{\delta E}{E} = \frac{\delta N}{N} + \frac{\delta I}{I} - \frac{\delta E}{E}$

$$\text{and } \frac{dE}{dI} = \frac{E}{I}$$



direction. Secondly, the foreign buying may have some restrictions such as import tariffs or export bounties, which means that the index numbers, which are based on internal prices, are not indicative of the comparative prices of the same commodity for the purposes of foreign trade. Thus, if  $n$  is the index number and there is a general import duty of 10% on goods, then the price at which goods will have to be bought in the other country is not  $n$  but  $n-10$ ; and if there is a bounty, the price of the exportable commodity is not  $n$  but  $n+10$ . In other words, the level of prices has to be adjusted for the tariff differences. Thirdly, the method of calculating index numbers is by no means uniform in all countries and the types of commodities taken into account will not be the same in the two countries in question.

Then again, the index numbers relate not only to those goods which enter into foreign trade, but several others whose prices may or may not be related to them. Moreover, exchange rates and prices are related as cause and effect and also as effect and cause. Consequently, the disequilibrium between index numbers and exchange rates may tend rather to adjust the prices than to affect the exchange rate. When prices have changed owing to radical alterations such as cost of production, then, of course, the exchange rates are bound to vary. It must also be remembered that the cost of import and export would play a very important part in determining the purchasing power parity and, lastly, that a country with a higher index ratio may have no use for those commodities in the country with the lower index ratio which have brought down that lower level of prices. If there is a general fall in prices, then it is possible that the exchange rate would follow.

"The price levels from the comparison of which the purchasing power parity between two countries is obtained are thus differentiated from the general price levels obtaining in those countries (a) by being restricted to the goods entering into international trade and (b) by being subject to the adjustments mentioned above (for freight, customs duties, import and export prohibitions, and regulations). The equation between the two price levels so determined gives a new parity round about which actual rates will fluctuate as in prewar days they fluctuated round mint par". (H. C. Walter, *Modern Foreign Exchange*, p. 152).

The reliability of the purchasing power parity theory was illustrated during the postwar reconstruction period when heavy depreciations of currencies changed internal prices very rapidly and the exchange rates like "Panting Time" toiled after them in vain. Though no equilibrium was established at any time between the three factors, and though there is no arithmetic proportion between two sets of figures, the tendencies are seen working all the time. A reference to table 24 given on pp. 278-9 will make this clear.

The theory of purchasing power parity may also be stated in another form. If, for some reason, an artificial change is made in the exchange ratio, internal prices must adjust themselves to external prices. If this is not done, there is created a disequilibrium of purchasing power parity with other countries and there will be increased buying in the country if its currency is under-valued, and increased selling to it if it is over-valued. But fixed charges such as interest, depreciation etc. which form a good proportion of the cost of production would not change and even wages do not adjust themselves easily and the prices of the exportable commodities may not follow the exchange rate. This has been illustrated, in the view of some economists, in the case of England. About the time when it returned to the gold standard, the following were the sterling rates on New York and the exchange rates corresponding to the index numbers in the two countries.

*Table 20—Under-valuation and over-valuation  
of sterling, 1924-25.*

Date.	Actual rate.	Purchasing power parity rate.
1924 January ..	426	456
July ..	437	439
October ..	448	430
1925 January ..	478	458
April ..	485	*473

Thus, in January 1924, sterling was under-valued by 7% while in October it was over-valued by 4% after having been

\* W. A. Brown Jr., *England and the New Gold Standard*, p. 216.

at purchasing power parity in July. In April 1925 when the return to gold was made, it was over-valued by  $2\frac{1}{2}\%$ . The result was that England had a higher level of internal prices and could not compete with other manufacturing countries on the basis of the gold standard. After about six years on the prewar ratio of  $\$4.86\frac{2}{3}$ , sterling has had to detach itself from gold and doubt is expressed whether it will not return to gold at a lower parity.

It is thought by some that a similar state of things came about in India in 1926, when the rupee was fixed at 18 pence and the best protagonists of the idea could only claim that prices had adjusted themselves to this ratio by 65% or that the rupee was being over-valued by 35%. But, they rightly argued, a return to 16 pence would mean a disturbance of prices by this 65% but there was only 35% more to be adjusted for the 18 pence ratio. As, however, there is nothing sacred in a round number of pence as the ratio, nor any mystic force in the number 18, it would appear that the proper solution was to fix the ratio at about  $17\frac{1}{2}$  pence and leave the price adjustment and exchange rate adjustment to work to this level with a disturbance, in either, of only about 3%, being a compromise between the *de facto* rate and the purchasing power parity rate between India and England.

Subject to these reservations and as a general guide to possible movements of exchange rates or price levels, the purchasing power parity theory may be taken as a valuable guide. Like all economic laws, however, it presupposes that other things remain equal; but other things do not remain equal and change very much, thus obscuring the operations of the economic laws.

## CHAPTER XLV.

### SOME SPECIAL FACTORS IN EXCHANGE.

*"On cabbages and kings"*

Olla podrida—Exchange and price levels—Inertia in action—

Nullifying tariffs—Exchange and taxation—"Revised" budgets—

The mother's skirt—Flight of capital—Return of capital.

A lecturer usually feels it his duty to say towards the close of his discourse "One word more and I am done" for the reason, probably, that he does not know how to end. In our Conferences and Federations, after several resolutions have been proposed and seconded by the star speakers, there are "omnibus" resolutions moved from the chair because no one will sponsor them. And in our dinners there is a dish which is called "aviyal"\* corresponding to 'olla podrida'. Vegetables in too small quantities are all mixed together to form a delicacy. There are, similarly, some stray thoughts, obiter dicta and fleeting fancies which are not worthy of separate chapters but which are too 'succulent' to be omitted. This introduction will serve as an excuse for this chapter and as a sort of connecting chain for the various subjects dealt with herein. Like the sauce in the "aviyal" it will give homogeneity to what might be otherwise described as disjointed matter.

\* The Tamil name of a favourite dish of the South Indians.

**Exchange Rates and Prices :—**We have seen that exchange rates are affected by changes in the price levels. An upward movement of prices means that other countries decrease their buying in that country, that is, its exports diminish in relation to imports and the external value of the currency unit falls. A downward movement of prices means that there will be increased buying in that country, increased exports from it and an increase in the external value of the currency. This relation between the exchange rates and price levels is a mutual one and if, sometimes, exchange rates will not listen to the call of index numbers, the latter must needs go where the former insist on going. Price levels will then have to adjust themselves to the exchange rates. It may well be questioned whether exchange rates would not move according to economic laws and move in sympathy with price levels, which represent more independent and fundamental economic factors. But the relation between the two is not that of cause and effect but may be compared to that of the see-saw as thus :—

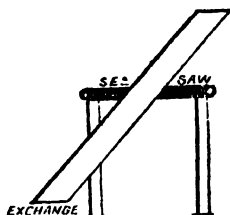


Diagram 20.

The see-saw of prices and exchange rates.

When economic forces are allowed free play, the tendency is for the plank to assume a position of equilibrium. If some new weight is added to one side the see-saw goes up and down a few times and settles down at a new angle at which comparative equilibrium is established. If some weight is taken off one side, it goes up and the other goes down. If one side goes too far down, the other goes too far up and if one little boy suddenly jerks the board down, the other little boy goes up so quick that he springs into the air, performs a somersault,

and is seen no more, leaving the plank without the balancing force at one end. This is what causes re-valorisation of currencies or institution of new currency units. It means that all hope of using the old currency so as to bring it into line with its older value must be abandoned.

But economic forces may not be allowed free play. The see-saw implies alternate movements and adjustments to a new angle. But if a powerful force, like that of a Government, holds up one of these little boys, the other little boy must permit himself to be forced into the angle required by the additional weight attached to the first one. It may be that he has a lusty voice, in which case, even the mighty Government may have to look small and take off its hands from *its* little boy.

We have seen that when England returned to the gold standard, the price level indicated an exchange rate of 4.75 gold dollars to the pound sterling, but the rate was fixed at 4.86 and prices had to do their best to follow the Government. Similarly, when Sweden decided to return to gold, the following price indices and exchange rates resulted :—

*Table 30—Price movements in Sweden following over-valuation of Kronas in 1922.*

Year.	Swedish Index $N_1$ .	U. S. A. Index $N_2$ .	$N_1/N_2$ .	Exchange rate ratio dollars in kronas.
1921	222	140	158	118.8
1922	173	138	125	102.4
1923	163	144	113	100.9
1924	162	140	116	101.0
1925	161	148	108	99.8
1926	149	143	104	100.1

The Government brought its weight and authority to bear on the exchange ratio and the other little fellow fought and bellowed but to no purpose. He had to follow and, from a high ratio of 158 to U. S. A. prices, his strength gradually failed him and like the "B" of our arithmetic sums, he had to allow "A", the exchange rate, to win and so he had to come down to 104. Inch by inch, he lost ground fighting hard as in trench warfare but he had to give in at last.

The following figures of the price movements in India between 1924 and 1930 are also illustrative of this theory. The index numbers have been converted with the year 1924 as basic year and the index numbers for India have been corrected for the exchange rates of the year :—

*Table 31—Price movements in India following over-valuation of the Rupee in 1925.*

Year		Exchange rate in pence.	Rupee index 1914=100	Corrected index (1924)	Average of four gold countries.
1924	...	17 $\frac{1}{2}$	173	100	100
1925	...	18	160	103	105
1926	...	17 $\frac{5}{8}$	149	96	99
1927	...	17 $\frac{9}{16}$	148	96	97
1928	...	18	145	93	98
1929	...	17 $\frac{1}{2}$	141	91	95
1930 June	...	17 $\frac{25}{32}$	116	75	83
1930 Dec.	...	17 $\frac{1}{2}$	101	65	75

The fall in India is over 40% in terms of the rupee but, even after allowing for the overvaluation, the fall is 35% against 25% in the gold standard countries.

The two cases cited above also illustrate two distinct principles. One shows the inertia of prices under static conditions, which prevents the price levels from moving with the exchange rates, creating the time-lag to which we have referred. The other shows the principles under dynamic conditions, which prevents the rate from stopping its motion when parity has been reached with the exchange rate. In the case of Sweden, the over-valuation of the krone took over five years to adjust, but in India the over-valuation of the rupee took only three, but the movement did not stop there and we find that the rupee became under-valued. If index numbers influence exchange, the rupee should purchase  $17\frac{3}{4}/18$  of what it did before, that is, the index number in terms of 1924 should be  $\frac{72}{71}$  of world price index or  $\frac{72 \times 75}{71}$  or 76, but it is only 65, that is, the corresponding exchange rate should be  $\frac{75 \times 18}{65}$  d or 21 pence nearly, while it was at the gold export parity for India, even up to October 1931.

**Exchange Rates and Duties :—**We have seen that the exchange rate can be changed without inflation or deflation in some cases by “management” by the currency authorities. Through the encouragement of exports or of imports, through a change in the exchange rate itself, a new balance of exports and imports is reached. Such tendencies may, however, be interfered with by the operations of tariff duties and bounties. For example, if the external value of the currency is raised, it decreases the cost of commodities to importers and they are encouraged to import more. But, if an import duty is imposed at the same time on some commodities, the advantage to importers of those commodities would be taken away and they would be just where they stood before the rate was raised. At the same time exporters are discouraged on account of the low local price they can realise for their goods in competition with other countries and such discouragement may be compensated in the case of some by a system of bounties. The cost of the exported goods thus becomes less to the exporters than the cost in the country and their profits remain unaltered. As the bounty has to be paid from general revenues the result is that the people as a whole pay for the benefit of the individual trade, unlike the case of import duties where the particular trade is taxed.

This principle may also operate through the removal of export duties, if any such exist, on the commodity. Thus, hides and skins in India are subject to an export tax of 5% *ad valorem* and, if there is a fall in the external value of the rupee, through a variation of 5% in the exchange rate, a corresponding reduction of the export duty would leave the trade in the same position as before. Similarly, the reduction of an existing import duty would reduce the cost of imported goods and thereby compensate importers for the higher price of goods in local currency following on its depreciation.

In the same way, the benefits to local trade, of import duties, may be nullified by a change in the external value of the local currency. This was recognised as early as 1900 when the Minority of the Fowler Committee wrote that a higher ratio



was "an unfair tax on native production while conferring a bounty on imported goods." A very illuminating example of such nullification occurred in the case of the cotton industry of India and the fixing of the exchange rate at 18 pence. For several years it was complained that the interests of the textile industry in India were subordinated to those of Lancashire. Even when the Government imposed a duty on foreign cloth, Lancashire interests made it impose what was called a "countervailing excise duty" on Indian production. The import duty thus became a revenue duty instead of a protective duty which it was on the face of it. When at last the cotton interests were able to get the countervailing excise duty removed, there might have resulted a condition when Indian goods could have struggled against foreign cloth. But it so happened that, just at that time, the exchange rate had been officially raised from 16 pence to 18 pence through a brief interregnum of 24 pence. The result was that importers of foreign cloth had to pay  $12\frac{1}{2}\%$  less than before for the same quantity of goods. The new exchange rate was thus the equivalent of a bounty of  $12\frac{1}{2}\%$  to foreign cloth and, as the cotton duty was only 15%, it resulted in a practical abolition of that duty.

The effect is also seen in other lines of production. The Indian sugar industry is believed to have suffered heavily on this score, because the cost of production in India remained practically the same as before, while the cost to the importer has decreased by the extent of the bounty given to him. The result is that India, which used to import 722,000 tons of sugar from Java and Mauritius in 1914, imported 851,000 tons in 1928-29 from Java alone and the total imports increased from 803,000 tons to 940,000 tons in the same period; but the area under sugarcane cultivation in India during the last twenty years has not increased at all, while there has been little increase in the production of 'gul' or white sugar in India. Other commodities like salt have also been increasingly imported and these assumed serious proportions so that the Government had recently to adopt the suggestions of the Tariff Board and impose new duties on some goods and increase the existing duties in the case of others.

**Exchange Rates and Taxation** :—We have seen that price levels in a country follow the exchange rate fairly closely when the latter is changed by the authorities, but otherwise it is the exchange rate that follows the price levels. When there is a fall in the purchasing power of the rupee, owing to the fall of the exchange value, wage-earners and creditors get less real value for the amounts due to them ; and if there is a rise in the purchasing power through an appreciation of the external value of the rupee, wage-earners and creditors benefit by the higher purchasing power. This argument applies to cash payments as well as to contracts to pay cash. For example, a person who has promised to pay 150 rupees on a later day, becomes, to that extent, a debtor, though he may not have borrowed at all. Thus, the Government was a loser by  $12\frac{1}{2}\%$  when the rate was raised from 16 pence to 18 pence and salaries paid in rupees were not revised at the time that the exchange rate was revised.

All creditors benefit by the same  $12\frac{1}{2}\%$ . Among such creditors the most important is the Government. Payments of taxes have to be made in local currency and the commodities produced have to be converted for paying the taxes. The amount of goods sold for this purpose will increase if the level of prices has changed upwards and decrease if the level of prices has changed downwards. In other words, a rise in the exchange rate is equivalent to an increase in the level of taxation and a fall in the rate means a remission of taxation. Taking the case of India which has a Central budget of about 135 crores and Provincial budgets of about 225 crores or a total tax demand of 360 crores, a fall in the exchange rate from 16 pence to 15 pence, about 7%, will ultimately work out to a remission of taxation of about 25 crores, in terms of goods sold by the people to pay the taxes. Similarly, a change to 18 pence means that prices fall by  $12\frac{1}{2}\%$  after some time and it is the same as an addition to taxation of  $12\frac{1}{2}\%$  of 360 crores or 45 crores. This can be better appreciated if we look at the rupee as a fraction of the sterling pound which, so far as we are concerned, determines the purchasing power of the

rupee. At 16 pence, the pound is equal to 15 rupees, and 360 crores of taxation is the same as £240 millions. If the rate is reduced to 15 pence, it is only equal to £225 millions, or there is a remission of £15 millions through the change in the rate. Similarly, at 18 pence the taxation is equal to £270 millions, meaning an increase of £30 millions in taxation.

The following "revised" budgets of the Central Government for 1926-27 and 1929-30 will show the effect of the increase in taxation through the rise in the exchange rate.

*Table 32—Budgets of the Government of India  
'revised' for higher exchange rate.*

Items.	1922-23		1926-27		1929-30	
			(in crores of rupees)			
	Original	Original	Original	"Revised"	Original	"Revised"
<b>RECEIPTS—</b>						
Customs, opium,						
salt etc. ..	74.5	75.5	83.9	79.4	89.3	
Other items ..	46.5	55.0	61.1	54.7	61.5	
Deficit ..	17.2	...	...	...	...	
Exchange difference ..	...	...	3.3	...	4.2	
<b>EXPENDITURE—</b>						
Military ..	72.3	59.2	69.1	58.6	66.0	
Other items ..	65.9	71.2	79.1	75.4	88.9	
Surplus ..	...	0.1	0.1	0.1	0.1	
Total ..	138.2	130.5	148.3	134.1	155.0	

It will thus be seen that the budget of 130 crores of 1926-27 was really one of 148 crores, that an additional 18 crores was found by taxation through the exchange rate and that the expenditure of the Central Government alone increased by that amount. Similarly, the budget of 134 crores for 1929-30 is really a budget of 155 crores representing an increase of 21 crores of taxation through the exchange rate. The budget figures have, therefore, to be taken with this reservation. Thus, though the military expenditure has apparently fallen by 14 crores, the difference is really only 6 crores.

**The Mother's Skirt** :—During the Great War, when man-power was not sufficient to meet the needs of national defence, it became necessary to draft in women to do work for which, till then, they were considered unfit, or which was considered beneath them. When they started to do the nation's work, the thing most in the way was the hobble-skirt and, in business-like manner, they resolved suddenly to adopt more rational clothing. The effect of this on the younger generation was very vexatious, even disastrous. For years they had been accustomed to regard the mother's skirt as the guiding principle in life, the one thing they could follow through any maze in the streets. With the adoption of rational dress, this landmark disappeared for the children and they began to lose themselves in even very ordinary crowds. Instead of the mother's skirt, the only real thing they could see was a pair of flesh-coloured stockings over legs with whose shape they were unfamiliar.

The gold exchange standard is similar to the mother's skirt. The country adopting it is like the war-time child and the mother is the ideal country with the gold standard to whose currency it has linked itself. If, for some reason, the ideal country is forced to depart from the gold standard, the exchange standard country does not know what to do. Its assets are all in the ideal country and, even if it desired to keep to the gold standard, it could not do so as the assets cannot be realised without heavy loss. On the other hand, the exchange standard relation, under such circumstances, subjects the country to the difficulties arising out of the repercussions of the variations in the currency of the ideal country, in addition to those arising from its own trade movements. While even the people in the ideal country could not have any specific hopes about the trend of the exchange movements there, people in the other country are not likely to have even vague ideas about it. No definite programmes could be made by its importers or exporters and the unsettled conditions must continue as long as the ideal country is off the gold standard. It is for this reason that the gold exchange standard has to be considered as a step towards the gold standard, which is the object to be achieved as soon as possible.

When Britain suspended the gold standard in September 1931, India had to do the same, and the rupee was linked with sterling and broke off with gold even nominally. It was then claimed by some that the country was virtually on the 16 pence ratio desired by one group of people. This is not an accurate assessment of the facts of the situation. So long as the rupee was linked to sterling, its value in international markets was extremely uncertain, until the pound itself returned to gold. Till then, it could not be said that the rupee had a gold value at all. What was true one day became untrue the next. It might be worth 16 pence when sterling was worth about \$4.30 per pound, but when sterling depreciated further to \$3.85 per pound, the rupee was worth only about 14¼ pence gold. The extent of the uncertainty attaching to the gold value of the rupee can be seen from the fact that, in terms of the dollar, the rupee was quoted at 360 instead of 274, or a depreciation of about 31% corresponding to a gold value of 12⅝ pence.

The argument for keeping the rupee attached to sterling is that, in any case, the rupee is going to be variable in value and it might just as well have some sort of stability arising out of its being linked with the pound sterling, even though the value of the pound itself was fluctuating. As the Government has substantial commitments in London, this would least disturb the budgets which would otherwise be at the mercy of the variations in the gold value of sterling.

The fact remains, however, that the rupee lost touch with the rest of the world. The preference that England obtained owing to the depreciation of sterling would have existed in India whether the rupee was attached to gold or to sterling. If the rupee had been linked to gold, it would not have unsettled our trade relations with other countries, beyond what is due to the successful competition of England. But the rupee being linked with sterling, created the same conditions in India which came about in England, by which exports to gold standard countries were stimulated while imports from them were correspondingly curtailed. One cannot, of course, be dogmatic as to whether this has been for the good of the country or against its true interests.

**Flight and Return of Capital** :—Speculative movement of funds from one country to another very often taken place owing to extraordinary variations in the exchange rate between the two countries. So long as these variations are under control by the currency authority, they are comparatively narrow and speculative movements of funds are not likely to occur on a large scale. In India, usually, there is a margin of about 3% between the highest and lowest limits to which the Government will allow the exchange rate to move. Between two gold standard countries there is a limit, generally much narrower, decided by the possibility of transporting bullion instead of allowing the exchange rate to vary. It often happens, however, that extraordinary conditions force the currency authority to lose control of the situation as happened in England in September 1931 and the exchange rate either moves up too high or moves down too low. It is then that speculative movements of funds arise.

For example, with a rupee stabilised legally at 16d., if there occur a movement which causes it to go up to 16½d., the Government has lost control of the situation. People in other countries might take the view that very soon the Government would be able to resume control, and they might remit funds from India to foreign countries by purchasing 16½d. per rupee in the hope that they could soon bring it back with profit by paying 16d. per rupee. People may also fear that the exchange rate is moving up further and if they have money in other countries which they have to bring into India, they might decide to bring them back by paying 16½d. for a rupee rather than have to pay 17d. for it later on. The first is a speculative movement of funds and the second is a legitimate return of funds. There thus arises either a movement of funds from the country or into the country according as people apprehend a future lower rate or a future higher rate.

In the same way, if the rate should move from 16d. to 15½d., the Government has again lost control of the situation. If there was confidence in the restoration to the previous level, people with funds abroad would purchase rupees at 15½d. hoping to sell them at 16d. per rupee and make a profit. On

the other hand, if people fear that the rate would go down further, the movement would be the other way round and people would decide to send monies abroad now and receive 15½d. for the rupee, rather than have to remit later on and obtain only 15d. per rupee. The first is a speculative movement. The second movement is referred to as "Flight of Capital," indicating a complete loss of faith in the currency authority. This only aggravates the situation. For, the lower rates caused by this extra demand becomes a new strain on the exchanges and there is created a kind of panic which results in a general scramble for foreign currency and further depresses the external value of the rupee. If the rate is moving up, the bringing in of funds from abroad would increase the supply of exchange and force the rate much higher.

There is an after effect of these movements. When conditions become stable again, there is the danger that the money which left the country for fear of lower rates would try to come back and increase the supply of exchange at a time when the rate might be moving up owing to trade influences or special action by the currency authority, and thus further accentuate the movement. Similarly, the transfer of funds from this country when conditions have settled down and the rate is perhaps moving down through trade influences or action by the currency authority, would increase heavily the demand for exchange and further depress the rate.

Just after the war, the currencies of several countries like Germany, Austria, France, etc. began to depreciate at such an alarming rate that in a few months' time the dollar was worth several times what it was before. Thus, the Austrian Crown was worth 70,000 to the dollar and the German Mark 21,000,000,000 per dollar. People therefore who had money in these countries found that their capital was depreciating heavily every day. It is said that a man left equal sums to two brothers. One put his money in the bank and lived a thrifty life. Another bought some hogsheads of beer and, after drinking almost all of it, was able to sell the remainder for his brother's bank balance.

In order to preserve as much of their money as possible, many people, therefore, remitted it to foreign countries. This aggravated the situation but, when the monetary systems were reorganised, people's faith was restored gradually and the foreign monies began to flow in, with the result that it became equally difficult for the currency authority to maintain the parities with other gold countries because of the violent disturbances caused by the inrush of capital from abroad. Gold began to move in and the Central Banks had to acquire it all or buy inordinate amounts of foreign currency and issue notes against them and the local currency became unnecessarily inflated.

The results of such a return of capital was well illustrated in France in 1929-30 when the wholesale prices fell down in sympathy with world movement, but the large volume of currency and credit in the country forced retail prices upwards at the same time. The following data show the results of this movement, with the index numbers reduced to gold prices in terms of 1913 levels.

*Table 33—Wholesale and retail prices in France, 1925-31.*

Year.			Wholesale index 1913 = 100.	Retail Index 1914 = 100.	Gold and foreign assets.	Note issue.
1925	...	...	135	121	18,458	49,993
1928	...	...	126	105	64,600	62,181
1929	...	...	124	113	67,582	68,571
1930	March	...	112	115	68,192	70,826
	June	...	108	116	69,654	72,594
	Sept.	...	106	120	74,000	73,053
	Decr.	...	99	121	79,725	76,436
1931	March	...	98	123	82,394	77,864

Even in the United States which has an unhealthy volume of gold and consequent increase in currency and credit, if her overseas investments of about \$20,000 millions should come back, she will find that retail prices and stocks will boom up unduly high without any relation to wholesale prices, or to conditions in the rest of the world, or to trade activities inside the United States. If the return of money takes place all too suddenly, the extraordinarily heavy demand for dollars might break down the exchanges and bring about a new kind of



moratorium when the Federal Reserve Banks may have to refuse to buy foreign currencies or even gold.

Similarly, in July to September 1931, about £200 millions of funds left London, bringing about the collapse of the gold standard in England. But, after some time, confidence would return and the funds would come to London again, bringing about an unnecessary strength for the pound which might be as embarrassing as the heavy withdrawals were.

One of the dangers arising out of the return of capital is that part of the new money may seek redemption from bank balances into local currency, bringing about an increase in note circulation which might endanger the gold standard in spite of large gold holdings, owing to the fact that, in ordinary times, bank deposits total about fifteen times the note issue. The sudden conversion of bank deposits becomes thus a danger to the gold standard itself.

Thus, both the flight and the return of capital could possibly be very harmful to the interests of a country by its influence on the exchanges and, through them, on the price levels, thus unsettling trade conditions both internally and internationally.

## COMMON ABBREVIATIONS

a/c	account	fl.	florin
a/d	after date	f. o. b.	free on board
<i>ad-val.</i>	<i>ad valorem</i>	f. o. r.	free on rails
a/s	after sight	f. p. a.	free of particular average
Bal.	balance	G. A.	general average
B. C.	bill for collection	Int.	interest
B/E	bill of exchange	J/A	joint account
B/L	bill of lading	Kr	Kreutzer, Krone, krona
B/O	buyer's option	L	lira, lire
B/P	bill payable	£	Pound
B/R	bill receivable	£E	Egyptian pound
Cert.	certificate	£P	Peruvian pound
c/f	carried forward	£T	Turkish pound
c & f	cost and freight	I./A	letter of authority
c. i. f.	cost, insurance and freight.	I./C	letter of credit
C. O. D.	cash on delivery	mks.	marks
Cr.	credit	M. T.	mail transfer
C. T.	cable transfer	O/D	on demand ; original and duplicate .
D/A	documents against acceptance	%	per cent
D/D	demand draft	%o	per mille
d/d	days after date	P & L	profit and loss
dis.	discount	pm.	premium
D/P	documents against payment.	P. O.	postal order
Dr.	debit	Pta.	peseta
d/s	days after sight	\$	dollar
f. a. s.	free alongside ship	S. O.	seller's option
fb.	francs belges	T. T.	telegraphic transfer
fcs.	francs	Zl.	zloty.

## ERRATA

Page	line	Error	Correction.
2	3 from bottom	acing	acting
15	16	as also hides and skins,	and hides and skins through Calcutta
48	13	in Calcutta—in Bombay	in Bombay—in Calcutta
79	1	promises	premises
99	4 from bottom	in London	in India
103	2	£5000	\$5000
116	10 from bottom	we	We
141	6 from bottom	1/6 $\frac{3}{4}$	1/6 $\frac{3}{4}$
230	last line	hey	they
232	17	undertook	undertook in practice
...	19	18 $\frac{1}{4}$	18 $\frac{1}{4}$
246	2	add a line before line 3 :— “that the same gold might be made the basis of currency issues in two”	<del>add</del>
...	6	expension	expansion
250	19	commonly	common
299	13	Hawtree	Hawtrey
322	27	Table 26	Table 27
337	7	£750 millions	£650 millions

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